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IMPUTED INTEREST RULES

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

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IMPUTED INTEREST RULES

FRIDAY, AUGUST 3, 1984

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Dole, Packwood, Chafee, Symms, Grassley, and Long.

[The press release announcing the hearing, opening statements of Senators Dole and Baucus and background material on the provisions of the Tax Reform Act of 1984 affecting the Federal tax treatment of interest on deferred payment sales of property follow:]

[Press Release No. 84-157]

FINANCE SUBCOMMITTEE SETS HEARINGS ON IMPUTED INTEREST RULES

Senator Bob Packwood, Chairman of the Subcommittee on Taxation and Debt Management of the Committee on Finance, announced today that a hearing will be held on the provisions of the Tax Reform Act of 1984 affecting the treatment of interest on deferred payment sales of property.

The hearing will be held on Friday, August 3, 1984 at 10:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

Senator Packwood announced that the hearing will focus on the changes to the imputed interest rules of Section 483 of the Internal Revenue Code, and the new Code Section 1274, relating to original issue discount arising from debt obligations issued in exchange for property.

Senator Packwood noted that during Senate and House consideration of the conference report on the recently enacted tax bill, an exemption was provided from the new Section 483 imputed interest rates for the sale of principal residence under $250,000 and for sales of farm land. At the time these changes were made, we promised to hold a hearing on the need for any further changes to the new imputed interest rate rules and particularly on the need for some exemption for seller-financed sales of small businesses. These hearings are in response to that promise.

STATEMENT OF SENATOR DOLE—HEARING ON IMPUTED INTEREST RULES

INTRODUCTION

First of all, I would like to thank the distinguished Chairman of the Subcommittee on Taxation and Debt Management for convening this hearing on the new deferred payment rules of the Deficit Reduction Act. At the time the Conference Report on the Act was being considered by the Senate, some concerns were expressed about the bill's changes to the so-called imputed interest rules of the tax code. An amendment I offered was adopted which I believe addressed the concerns of most Members. My amendment essentially retained current law for seller financing of principal residences costing less than $250,000, and for sales of farm land costing under $1 million. There were some Members, however, who were concerned

about transactions not covered by my amendment, including the distinguished Senator from Montana, Senator Melcher. A commitment was made to hold hearings on the outstanding issues of concern to Senator Melcher and others, and this hearing was convened in response to that commitment.

I believe the amendment I offered, to ameliorate the effect of the new law for principal residences costing less than one-quarter of a million dollars, and sales of farm land costing less than one million dollars, is responsive to the legitimate concerns of farmers, ranchers, and homeowners in my State of Kansas and throughout the country.

IMPUTED INTEREST RULES

The deferred payment rules of Section 483 of the tax code have, of course, been part of the tax law for more than twenty years. Although they are commonly referred to as the "imputed interest rules" this shorthand expression is sometimes confusing, since what the rules really do is simply recharacterize as interest installment payments that a taxpayer has called principal, or has not characterized at all.

The notion that a minimum portion of deferred installment payments must be treated as interest sometimes makes people feel that the Government is improperly intruding into their private transactions. I believe this perception is misguided because it ignores the substantial benefits the tax code provides for payments that are improperly characterized as principal rather than interest—namely, favorable capital gains treatment for sellers, and accelerated cost recovery and investment tax credits for buyers. If the tax code didn't provide these preferences, or if taxpayers and tax favored industries did not zealously claim them, the tax laws could afford to be completely indifferent as to how private parties structure their transactions. But in a tax code filled with special exceptions and preferences, the system must have safeguards against abuses.

CHANGES MADE BY DEFICIT REDUCTION ACT

The major change enacted by the Deficit Reduction Act was a statutory rule sought by the Treasury Department and included in the Administration's budget proposals to insure that the interest rates set by Treasury regulations as adequate interest would properly reflect current market interest rates. In addition, interest in certain business transactions was, in effect, required to be accounted for on the accrual method by both parties. This is the effect of applying the original issue discount or OID rules.

HISTORICAL INTEREST RATES UNDER SECTION 483

The reason for adopting a statutory formula for adjusting imputed interest rates can be seen graphically by looking back to 1964 when these rules first took effect. In 1964, the imputed interest rate was 5 percent, approximately 120 percent of the yield on 10 year Treasury securities. This rate was realistic at the time. Indeed, the yield on new home mortgages was approximately 5.8 percent. With rising interest rates, the imputed interest rate was raised to 7 percent in 1975, and 10 percent in 1981. But in 1983, while home mortgages were yielding close to 13 percent the imputed interest rate remained at 10 percent.

TAX AVOIDANCE AND DEFERRED PAYMENT SALES

I am aware that there are some who believe that a below market interest rate given in connection with seller financing is unrelated to the purchase price of the property, or that discount financing is not "paid for" by an increased purchase price. That view is contrary to common sense and experience in the real estate and business world. The cash price, where a buyer obtains his own financing, is in my experience lower than when discount rate seller financing is provided. This is because a seller for cash can invest his money at market rates. By arranging to receive an economic return in the form of higher amounts of capital gains and lower amounts of interest, the seller can obtain an unearned and unintended tax benefit on top of his economic profits. The Code has been clear on this point since 1963. The 1984 changes are essentially "loophole closers."

It would be a mistake to permit "loopholes" in the application of these rules to be used by generally more affluent buyers and sellers of business and investment property, at the expense of higher tax rates—or greater Federal borrowing costs—that would be borne by the average taxpayer.

Statement by Senator Max Baucus

INTRODUCTION

Mr. Chairman, thank you for calling this hearing. It gives us a change to review the tax bill's imputed interest provisions, and to decide whether further changes are necessary.

I think they are.

Therefore, I have cosponsored Senator Melcher's bill, S. 2815, which would reduce the imputed interest rates for sales of many farms, residences, and small businesses. I hope that the Finance Committee will quickly approve this legislation and send it to the Senate floor so that we can pass it before new rules go into effect in January.

BACKGROUND

When someone sells property on a deferred basis, the principal he receives is treated as capital gain and the interest he receives is treated as ordinary income. Because capital gains are taxed at much lower rates than ordinary income, a seller may have a tax incentive to overstate principal and understate interest; when the property sold is depreciable property, the buyer may have a similar incentive, because he can take accelerated depreciation deductions (and in some cases an investment tax credit) based on the amount of the principal but not the interest.

Some time ago, Congress sought to limit the effect of these tax incentives by assuming, for tax purposes, that a deferred payment transaction includes a basic interest component. Specifically, Tax Code section 483 directs the Treasury Secretary to issue regulations setting "safe harbor" and "imputed" interest rates; if the seller doesn't actually charge interest of at least the safe harbor rate, he is assumed to have charged interest of the higher imputed rate. Currently, the safe harbor rate is 9 percent and the imputed rate is 10 percent. Therefore, if a seller doesn't charge interest of at least 9 percent, he is assumed, for tax purposes, to have charged interest for 10 percent.

THE ADMINISTRATION PROPOSAL

The Administration apparently wasn't satisfied with this situation. In its most recent set of budget proposals, the Treasury Department asked Congress to revise section 483 so that the rate no longer is set by the Treasury Department, but instead "floats" along above the T-bill rate. Specifically, the safe harbor rate will be 110 percent of the T-bill rate and the imputed rate will be 120 percent of the T-bill rate.

Eventually, this provision was included in both the House and Senate tax bills, and adopted as section 41(b) of the Tax Reform Act.

ANALYSIS

Mr. Chairman, it's clear, from the Administration's original description of the problem it perceived, that the new imputed interest rate provision was aimed at big commercial developers who use sophisticated methods to maximize the tax shelter benefits of their transactions.

But the provision actually went way beyond that. It affected ordinary homeowners, farmers, ranchers, and small businessmen who resort to seller-financing rather than bank financing. As a result, it would have had an especially harsh effect in the West, where interest rates generally are higher than elsewhere and where seller-financing is more heavily relied on.

The people I'm talking about are not sophisticated developers engaging in elaborate tax scams. They're ordinary people who simply can't sell their homes, farms, ranches and small businesses at prevailing market rates.

Under the section 41(b) provision, the government would have told these people that they either have to sell at prevailing rates or else suffer a tax penalty. Based on today's rates, this meant that, instead of charging 9 percent, they'd have had to charge about 15 percent.

This would have been an unnecessary and indeed counterproductive intrusion. According to the National Association of Realtors, it could have reduced home sales by 500,000 a year. At a time when increasing interest rates already are undermining the housing market, this would have been devastating.

THE CONFERENCE REPORT

Unfortunately, the section 41(b) imputed interest rate provision slipped through the House, the Senate, and the Conference Committee without anyone discovering its potential impact on homes, farms, ranches, and small businesses.

Only after the Conference Committee had ratified the provision did I learn, from an article in the Wall Street Jounal and from the National Realtors Association, that, unlike another related provision in the bill, the imputed interest rate provision contained no exception for principal residences, farms, and ranches; nor did it contain an exception for small businesses. As soon as I learned this, there was an attempt to modify the Conference Report provision; unfortunately, it was blocked by one of the House conferees. Nevertheless, at the end of the conference on Friday night, I described the potential problem and urged my fellow conferees to reexamine the issue as soon as possible.

THE CONCURRENT RESOLUTION

Shortly after that, we were able to modify the provision. When the Senate debated the concurrent resolution making technical corrections in the tax bill, Senator Dole offered an amendment that revised section 41(b) to exempt sales of homes worth less than $250,000 and sales of farms worth less than $1 million.

This amendment, supported by the National Association of Realtors, was step in the right direction, and I supported it.

However, it didn't go far enough. Therefore, I cosponsored Senator Melcher's amendment that would have also exempted sales of residences other than principal residences and sales of small businesses. Unfortunately, this amendment was defeated.

TODAY'S HEARING

Today's hearing gives us an opportunity to take another look at section 41(b).

As I see it, even after the floor amendments, section 41(b) still is unnecessary and counterproductive. It applies to sales of farms worth more than $1 million—and in Montana, there's plenty of average farmers whose farms are worth that much—and it applies to small businesses and vacation homes. But there's really no need for seicotn 41(b) to apply to these things. The people involved in these transactions are *not* the sophisticated developers that section 41(b) originally was aimed at. They're ordinary people caught in a web spun by an overzealous Treasury Department.

THE MELCHER BILL

We can solve the problem simply.

Senator Melcher's bill, S. 2815, does what needs to be done. It reduces the safe harbor and imputed interest rates for sales of *any* homes worth less than $250,000, for farmland worth less than $1.5 million, and for small businesses worth less than $500,000. That way, it limits section 41(b)'s impact to the large, sophisiticated developers it originally was aimed at.

I am an original cosponsor of S. 2815. It is sound legislation that is important to ordinary taxpayers, to the housing industry, to farmers and ranchers, and to operators of small businesses. I think that this Committee should approve the bill, and report it favorably to the Senate floor, as soon as possible.

Mr. Chairman, in closing I want to thank Senator Melcher. He has been working on this issue for a long time, and has done a great job. His tireless work on behalf of average taxpayers should be applauded.

PROVISIONS OF THE TAX REFORM ACT OF 1984 AFFECTING THE FEDERAL TAX TREATMENT OF INTEREST ON DEFERRED PAYMENT SALES OF PROPERTY

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON AUGUST 3, 1984

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Committee on Finance has scheduled a hearing on August 3, 1984, on the provisions of the Tax Reform Act of 1984 (P.L. 98-369) affecting the Federal income tax treatment of interest on deferred payment sales of property.

In the press release announcing the hearings, Subcommittee Chairman Packwood stated that the hearing will focus on the changes to the imputed interest rules of section 483 of the Internal Revenue Code made by the 1984 Act, and on section 1274 of the Code as added by that Act. Section 1274 relates to original issue discount on certain debt obligations issued in exchange for property.

Part I of the pamphlet is an overview. Part II describes the imputed interest and original issue discount rules that were in effect prior to the 1984 Act and the problems that gave rise to the modifications made by the Act. Part III describes the changes made by the 1984 Act. Finally, part IV discusses recently introduced legislation affecting amended section 483 and the new original issue discount provisions.

I. OVERVIEW

The amendments to section 483 and the enactment of new section 1274 in the Tax Reform Act of 1984 (P.L. 98-369) (hereafter referred to as the "1984 Act") were part of a larger legislative effort aimed at reducing the use of abusive tax shelters and at reducing or eliminating the tax benefits of certain transactions that were either unintended or were in excess of what Congress intended when the relevant provisions of law were enacted. One major series of reforms accomplished by the Act was in the so-called "time value of money" area. The time value of money refers to the difference in value between the right to an amount today and the right to the same amount at some time in the future. The value of the right to receive $1 today is greater than the right to receive $1 ten years from today, by the amount that could be earned by investing $1 for ten years.

Prior to the Act, a number of provisions of the Internal Revenue Code ignored, or failed to account properly for, the time value of money. Section 483, which recharacterizes payments of principal and interest in certain transactions where the parties have stated no interest or have stated interest at a rate below a safe-harbor rate fixed by Treasury regulations, was deficient in this respect. Section 483 was enacted in 1963 to require taxpayers involved in deferred payment sales of property to state adequate interest in the transaction, and, thus, to avoid overstating the purchase price of the property. Prior to the Act, section 483 did not require that safe-harbor interest be computed on an economic basis, that is, on a "constant interest" or "yield-to-maturity" basis. Moreover, the safe-harbor rate established by the Treasury Department and modified from time to time in recent years consistently lagged behind actual market rates.

Although the provisions relating to the annual inclusion and deduction of original issue discount on certain debt obligations (the "OID rules," secs. 1232 and 1232A of the Code as in effect prior to the 1984 Act) were amended in 1982 to require economic accruals of interest, these statutory rules by their terms did not apply to obligations issued in exchange for property unless either the debt obligation or the property was traded on an established securities exchange.

Many tax shelters were taking advantage of the limited coverage of the the original issue discount rules and the deficiencies of section 483 to achieve unintended tax benefits. In addition, many transactions in which the principal purpose was not necessarily tax avoidance were producing tax consequences that clearly failed to reflect economic realities, resulting in tax benefits to the parties and a substantial loss of tax revenues to the Federal Government.

The amendments made by the Tax Reform Act of 1984 were intended to remedy this situation by applying the OID rules to many

debt-for-property transactions and bringing the rate used to test the adequacy of stated interest in a transaction more in line with market rates. The amendments are generally effective for transactions occurring after December 31, 1984.

II. TREATMENT OF DEFERRED PAYMENT TRANSACTIONS UNDER PRIOR LAW

Under the law prior to the 1984 Act, section 483 and the OID rules addressed two distinct concepts. Section 483 dealt with the measurement of principal and interest in a sale or exchange of property involving deferred payments. The OID rules dealt with the timing of inclusion and deduction of interest on debt instruments.

Measurement of principal and interest

When property is sold and the parties agree to defer payment of all or a portion of the purchase price, a loan transaction has occurred in conjunction with the sale. The seller has lent the purchaser the difference between the purchaser's down payment, if any, and the amount the seller would have accepted for the property if the full amount had been paid at the time of sale. The terms of this purchase money loan may not be expressly stated in the sales contract. For example, the contract may simply require payment of stated amounts on specified dates, with no designation as to which portion of a payment is attributable to principal (i.e., is intended to reimburse the seller for the property) and which portion is attributable to interest (i.e., is intended to compensate the seller for the forebearance of the use of money).

Generally speaking, if the contract specifies a current market rate of interest and requires the purchaser to pay interest on the outstanding loan balance at least annually, there is little or no distortion in the taxation of the parties. The seller's gain on the sale, the purchaser's basis for the property, the seller's interest income, and the purchaser's interest expense for Federal income tax purposes follow the economic substance of the transaction. However, when the contract states an inadequate interest rate or does not require payment of the interest on a current basis, the purchase price of the property has been overstated.[1] What are in economic reality interest payments will have been improperly characterized as payments of sales price or loan principal.

This improper characterization of interest as sales price, although of no economic significance to the parties, may have important tax consequences. If the property sold was a capital asset to the seller, the seller will have transformed interest income (which should be taxable currently as ordinary income) into capital gain

[1] To illustrate how an understatement of the interest element of a transaction overstates the purchase price, assume a sale of property with a value of $100 and an actual market interest rate of 12 percent. Buyer agrees to pay and seller agrees to accept $179 at the end of 5 years (consisting of $100 principal and $79 interest). The parties could, by artificially stating an interest rate on the sale of 9 percent compounded semiannually, fix the principal amount at $115 ($179 discounted to present value at a rate of 9 percent is approximately $115). If recognized for tax purposes, the purported principal amount would overstate the value of the property by $15.

(which is taxable at lower rates and whose taxation is generally deferred until paid). Property that is depreciable in the hands of the purchaser will have an artificially high tax basis, resulting in overstated cost recovery deductions and (if section 38 property is involved) investment tax credits. The cost recovery deductions available to the purchaser under the accelerated cost recovery system (ACRS) may more than offset the reduced interest deductions attributable to the use of a below market rate of interest. In some cases, the present value to the purchaser of the ACRS deductions and investment credit may far exceed the present value of the obligation to pay the seller amounts in the distant future.

Timing of inclusion and deduction of interest

Regardless of the amount of interest payable under a deferred payment sales contract, distortions to the taxation of the parties may occur if the contract does not call for interest to be paid currently. Failure to require payment of interest at least annually may result in a mismatching of the interest income reported by the seller and the corresponding interest expense claimed by the purchaser, where the seller reports income on the cash method and the purchaser on the accrual method. While the accrual method purchaser deducts the interest payable on a current basis, the cash method seller does not include this amount in income until it is received in a subsequent period. The present value to the government of income included by the lender in the subsequent period will be less than the present value of the deductions claimed by the purchaser. As the disparity between the time when the purchaser deducts the interest expense and the time when the seller reports the interest income increases, the cost to the government increases geometrically.

The distortion to the taxation of the parties is magnified if the accrual method purchaser computes its interest deduction using a noneconomic formula, such as straight-line amortization, simple interest, or the "Rule of 78's."[2] This has the effect of overstating the interest accrual in the earlier years of the loan, thus accelerating the purchaser's deductions. An economic accrual formula would take into account the compounding of interest, that is, the fact that more interest economically arises in the later periods because the amount of the debt is increased by the accrued but unpaid interest from earlier periods.

In 1983, the Internal Revenue Service issued a revenue ruling which proscribes the deduction of interest in an amount in excess of the amount of the economic accrual of interest for the taxable year. In Rev. Rul. 83-84, 1983-1 C.B. 9, the Service ruled that the amount of interest attributed to the use of money for a period between payments must be determined by applying the "effective rate of interest" on the loan to the "unpaid balance" of the loan for that period. The unpaid balance of the loan is the amount bor-

[2] The Rule of 78's is a formula for allocating interest over the term of a loan that results in much larger deductions in the early years. To illustrate, in the case of a 30-year loan, interest would be calculated under the Rule of 78's by first taking the sum of the integers from 1 through 30 (i.e., 1+2+3+4....and so on up to 30), or 465. The borrower would accrue 30/465 (or 6.45 percent) of the total interest in the first year, 29/465 (or 6.24 percent) in the second year, and so on until the 30th year when 1/465 (.22 percent) of the interest would be accrued.

rowed plus the interest earned, minus amounts previously paid. The effective rate of interest is a measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of values received to the amount and timing of payments made; it is thus a reflection of the cost of the amount borrowed for the time it is actually available. The effective rate of interest, which is a uniform rate over the term of the loan and is based on the amount of the loan and the repayment schedule, will produce the true cost of the amount borrowed when applied to the unpaid balance of the loan for a given period. Rev. Rul. 83-84 does not apply to certain short-term, self-amortizing consumer loans that require level payments at regular intervals at least annually.[3]

Although Rev. Rul. 83-84 was consistent with present-law rules for computing original issue discount (under secs. 1232A and 163(e)), generally accepted accounting principles, and sound economic theory, some taxpayers, on advice of counsel, were not complying with its mandate.

Original issue discount rules

Concern over the mismatching of interest income and deductions by lenders and borrowers in loan transactions led to the enactment in 1969 of provisions requiring ratable inclusion in income of original issue discount (OID) by the holder of a debt obligation. OID arises when a borrower agrees to repay a lender more than the amount initially borrowed. The difference between the issue price of an obligation (the amount received by the borrower) and its stated redemption price (the amount that must be repaid to the lender) compensates the lender for the use of its money and thus performs the same function as stated interest.[4]

The 1969 amendments to the Code required OID to be taken into account annually by both lenders and borrowers, regardless of their accounting method. Under these provisions, borrowers were allowed to deduct OID on a straight-line basis over the life of the loan, resulting in interest deductions larger in the earlier years than justified under an economic accrual formula. Lenders were correspondingly required to report a disproportionately large amount of interest income in the early years of the loan.

In recognition of the shortcomings of these rules, further amendments were made to the OID provisions in 1982. Under the 1982 rules, reporting of OID on a constant interest basis is required of both issuers and holders of obligations subject to the OID rules. Thus, OID was required to be allocated over the life of the bond through a series of adjustments to the issue price for each "bond period" (generally, each one-year period beginning on the date of issue of the bond and each anniversary thereof). The adjustment of the issue price for each bond period is determined by multiplying the adjusted issue price (i.e., the issue price as increased by adjustments prior to the beginning of the bond period) by the bond's yield to maturity, and then subtracting the interest payable during the

[3] Rev. Proc. 83-40, 1983-1 C.B. 774.

[4] See *United States* v. *Midland Ross Corporation*, 381 U.S. 54 (1965) (a case that arose under the 1939 Code).

bond period. The adjustment of the issue price for any bond period is the amount of the OID allocated to that bond period.

The OID rules prior to the 1984 Act did not apply to obligations issued by a natural person,[5] obligations not constituting capital assets in the hands of the holder, or obligations issued in exchange for property where neither the obligation nor the property received was publicly traded. The failure to include discount obligations issued for nontraded property where the obligations were themselves not traded resulted from the perceived difficulty in these situations of determining the issue price of the obligation (i.e., the value of the property sold) and, therefore, the amount of the OID implicit in the obligation.[6] If the value of property is not readily ascertainable, the allocation between principal and interest on the obligation becomes uncertain.

Imputed interest on deferred payment sales of nontraded property

Under prior law, parties to a deferred payment transaction involving a sale of property not within the OID rules might nonetheless be subject to the unstated interest rules of section 483. If the parties do not specify a minimum (safe harbor) rate of interest to be paid by the purchaser, section 483 imputes interest at a rate set by the Treasury Department. However, prior to the 1984 Act neither the safe harbor interest rate (also fixed by the Treasury) nor the imputed rate under prior law varied according to the length of time over which deferred payments are made or the maturity of the deferred payment obligation. The current safe harbor rate under section 483 prior to the 1984 Act was 9 percent simple interest; the imputed rate was 10 percent, compounded semiannually.

If interest is imputed under section 483, a portion of each deferred payment is characterized as interest. Under the rules prior to the 1984 Act, the allocation between interest and principal was made on the basis of the relative amounts of the payments, without regard to the time that had elapsed since the sale. Amounts treated as interest under section 483 are included in the income of the lender in the year in which the payment is received (in the case of a cash method taxpayer) or due (in the case of an accrual method taxpayer). The borrower likewise deducts this imputed interest in the year in which payment is made or due.

The simple interest safe harbor rate under prior law did not reflect an economic rate of interest for three reasons. First, although the safe harbor and imputed interest rates changed over the years, they did not keep up with market interest rates. Second, a simple

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[5] Prior to 1982, the OID provisions applied only to corporate and taxable government obligations. The 1982 rules extended these provisions to noncorporate obligations other than those of individuals.

[6] The 1969 Act as originally reported by the House Ways and Means Committee and the Senate Finance Committee included within its scope all transactions involving issuance of a debt obligation for property. A Senate floor amendment added the exception for obligations issued for nontraded property, reflecting concern that the parties to such sales might take inconsistent positions on valuation. See letter from John S. Nolan, Deputy Assistant Secretary of the Treasury (Tax Policy), to Sen. John J. Williams (dated November 28, 1969), 115 Cong. Rec. 36730-36731 (1969). The Conference Report to the Technical Corrections Act of 1982, which repealed the exception to section 1232 for publicly traded obligations issued in a reorganization, acknowledged the continued existence of the mismatching problem in transactions involving nontraded property, and stated that further corrective legislation might be appropriate in the near future if the Treasury Department was unable to deal with the problem administratively. H.R. Rep. No. 97-986, 97th Cong. 2d Sess., p. 21 (1982).

interest computation ignores the compounding of interest on unpaid interest which occurs as an economic matter. For example, a debt obligation bearing a stated rate of 9 percent simple interest payable at the end of 30 years actually bears interest at a rate of 4½ percent on a constant interest basis. The use of a simple interest safe harbor rate may allow taxpayers to avoid imputation of interest under section 483 even though the stated interest is significantly below prevailing market rates. Finally, the use of a single rate for all obligations regardless of the length of maturity fails to reflect the fact that lenders typically demand different returns depending on the term of the loan.

As explained above, understatement of the interest element of a deferred payment transforms what is in reality interest into principal or sales price, with a resulting overstatement of the tax basis of the property purchased. In such a case, the purchaser is able to claim excessive ACRS deductions and investment tax credits. These deductions and credits may have a materially higher present value than the interest deductions that would be available if an economic rate of interest were provided. Tax shelters have taken advantage of the low safe harbor rate provided under section 483 to obtain excessive ACRS deductions and investment credits.

Under the rules prior to the 1984 Act, tax shelters exploited the method of allocating unstated interest among payments by structuring sales transactions so as to accelerate several years' interest charges into the year of the sale. For example, assume property with an established fair market value of $100,000 was sold for $2,500 in cash and two notes, one obligating the purchaser to pay $100,000 six months and one day after the sale, the other obligating the purchaser to pay $100,000 at the end of 30 years.[7] Since the notes have no stated interest, the rules of section 483 prior to the 1984 Act would have imputed interest at a rate of 10 percent, compounded semiannually. Applying this rate, the total unstated interest in the deferred purchase contract was $99,408 (the $200,000 face value of the two notes less $100,592, the sum of their present values). Since the deferred payments are made in two equal installments, the total unstated interest of $99,408 was allocated under prior law one half (i.e., $49,704) to the first note and one half to the second. Thus, the purchaser in this example was arguably [8] entitled to deduct as interest almost one-half the cost of the property in the year of purchase when, economically, virtually all of the imputed interest is paid in the second payment.[9] The major portion of the purchase price was reflected in the payment of the first note, since the payment due in 30 years discounted at a market rate of interest had little present value (slightly more than $3,000 in this example).

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[7] The present value of the cash and the notes, assuming the market rate of interest is 12 percent, would have been approximately $100,000.

[8] It is possible that the rules that restrict deductions for prepaid interest may apply to limit the amount of the interest deduction in this situation.

[9] Although the section 483 rules would have otherwise required the seller to recognize the same ordinary income of $49,704 in the year of payment, the seller might have been able to avoid this result by disposing of the first note within six months of the sale.

III. CHANGES MADE BY THE TAX REFORM ACT OF 1984

A. Extension of OID rules

Overview

The Tax Reform Act of 1984 extended the rules for periodic inclusion and deduction of original issue discount by lenders and borrowers to debt instruments issued for nontraded property and which are themselves not publicly traded, effective for transactions occurring after December 31, 1984. The Act also repealed the exemption for obligations issued by individuals and the exemption from the income accrual requirement for cash method holders of obligations not held as capital assets. As discussed below, exceptions from the rules are provided to ensure that they will not ordinarily apply to routine transactions of individual taxpayers, or to *de minimis* transactions of individuals and others.

If either side of a transaction is publicly traded, the market value of the traded side will determine the issue price of an obligation, as under prior law. Where neither side is traded, however, the issue price and the amount of the OID will be determined by imputing interest to the transaction at a rate higher than the safe-harbor rate in cases where inadequate interest has been provided for. The safe-harbor interest rate used to test the adequacy of interest and the imputed interest rate will be equal to specified percentages of the "applicable Federal rate."

Applicable Federal rate

The safe-harbor rate will be 110 percent of the applicable Federal rate, and the imputed rate 120 percent of that rate. The applicable Federal rate will be a rate based on the average yield for marketable obligations of the United States Government with a comparable maturity. Federal rates will be redetermined by the Secretary at 6-month intervals for 3 categories of obligations: short-term maturity (3 years or less); mid-term maturity (more than 3 years but not more than 9 years); and long-term maturity (more than 9 years). The applicable Federal rate for a transaction will be the rate in effect for that category of maturity as of the first day there is a binding contract for the sale or exchange.[10]

Transactions to which OID rules apply

The adequacy of the interest element in a transaction will be determined by comparing the stated redemption price of the debt instrument at maturity to (1) the principal amount determined by

[10] Preliminary estimates indicate that the short-, mid-, and long-term safe harbor rates (i.e., 110 percent of the applicable Federal rates) for the period July 1 through December 31 would be approximately 11.25 percent, 12.65 percent, and 13.25 percent, respectively, if the new provision were currently in effect.These figures are based on yields of Government obligations for the 6-month period ended March 31, as required by the statute.

discounting, at a rate equal to 110 percent of the applicable Federal rate, all payments due under the instrument (the "testing amount"), and (2) the principal amount stated in the debt instrument.[11] The obligation will be subject to the OID rules only if either of these amounts is less than the stated redemption price and some or all of the payments under the instrument are due more than 6 months after the sale or exchange. Accordingly, these rules will be inapplicable so long as interest has been provided at a fixed rate at least equal to 110 percent of the applicable Federal rate and is payable unconditionally at the stated rate on an annual basis.[12]

Determination of principal amount

If the safe-harbor rate is not satisfied, the principal amount of the instrument will generally be deemed to be the sum of the present values of all payments due under the instrument using a discount rate equal to 120 percent of the applicable Federal rate. In addition, if the transaction involves a potentially abusive situation, the principal amount of any debt instrument received in exchange for property may be neither more than nor less than the fair market value of the property. A potentially abusive situation includes any transaction involving a "tax shelter" as defined in section 6661(b)(2)(C). It may also include any other situation which because of (1) recent sales transactions, (2) nonrecourse financing, (3) financing with a term beyond the economic life of the property, or (4) other circumstances, is of a type which the Secretary of the Treasury by regulations identifies as having a potential for abuse.

Determination of amount of OID

The amount of original issue discount subject to the periodic inclusion and deduction requirements of the OID rules (sec. 1232A of prior law) will be the difference between the issue price and the stated redemption price at maturity. The issue price for this purpose will be the principal amount determined by discounting all payments using a discount rate equal to 120 percent of the applicable Federal rate (limited in accordance with the rule described in the preceding paragraph, where appropriate), or the principal amount payable at maturity if interest has been stated at least at the safe harbor rate. The OID determined under this formula will be treated as interest for all purposes of the Code (e.g., secs. 163, 189, 265, and 543).

Likewise, the allocation between principal and interest resulting from application of the OID rules will determine the principal amount of the loan (and, therefore, the cost of the property). For example, under section 453 (relating to installment sales), the total

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[11] In enacting these provisions, the Congress stated that it believed that the use of a safe-harbor rate equal to 110 percent of the applicable Federal rate will roughly correspond to the rate at which a good credit risk could borrow. Consequently, the Congress felt that discounting all payments at this rate should provide a liberal estimate of the principal amount (and, therefore, the value of the property) involved in the transaction. S. Rept.98-108, 98th Cong., 2d Sess, Vol. 1, p. 254, n. 13.

[12] Thus, the OID rules will be inapplicable only in cases where there is a matching of interest income and deductions by the parties. If, for example, the parties provide that interest is payable annually at a rate equal to the applicable Federal rate but accrues at a higher rate (based on a fixed rate of compound interest), the transaction will be within the OID rules and interest will be included and deducted annually at the higher stated rate.

contract price will include debt of the purchaser only to the extent of the principal amount of the debt instrument as determined under these provisions.

Exceptions

Under the 1984 Act, the periodic inclusion and deduction rules will not apply to debt instruments received by an individual, estate, or testamentary trust, by a small business corporation (as defined in section 1244(c)(3), relating to losses on small business stock), or by a partnership whose capital is not in excess of the limits specified in section 1244(c)(3), in exchange for a farm. This exception will apply only if it can be determined at the time of sale that the sales price cannot exceed $1 million. An aggregation provision, to prevent avoidance of the $1 million limitation by splitting a singie transaction into several smaller transactions, requires that sales and exchanges which are part of the same transaction or a series of related transactions be treated as one sale or exchange.

Exceptions are also provided for (1) debt instruments received by an individual as consideration for the sale or exchange of a principal residence (as defined in sec. 1034); (2) cash-method issuers (but not holders) of debt instruments issued in exchange for property substantially all of which will not be used by the issuer in a trade or business or held by the issuer for the production or collection of income; (3) debt instruments received as consideration for the sale or exchange of property if the sum of the payments due under the instrument (whether designated principal or interest) and under any other debt instrument received in the sale, and the fair market value of any other consideration received in the sale, does not exceed $250,000 [redacted]); and (4) sales of land between family members with an aggregate sales price of $500,000 or less. Finally, an exception is provided with respect to a payment attributable to a transfer of a patent that qualifies for capital gain treatment under section 1235, provided such payment is contingent upon the productivity, use, or disposition of the patent. Thus, the exception would not apply in the case of a deferred lump sum amount payable for a patent.

B. Modification of Rules for Making Allocations of Principal and Interest in Other Deferred Payment Transactions

Since the scope of the OID rules is significantly expanded under the 1984 Act, the scope of section 483 under the 1984 Act accordingly is reduced. Section 483 will apply only in the case of deferred payment transactions involving a sale of property which are exempted from the OID rules (e.g., sales of a principal residence; certain sales of farms; transactions involving total payments of $250,000 or less; and that portion of a debt instrument subject to section 483(f) (as redesignated by the Act). The Act revises the interest rates used in section 483 to conform to the new rates used for obligations subject to the OID rules, effective January 1, 1985. Thus, the 483 rules will apply using a compound safe-harbor and imputed interest rates, which will vary according to the maturity of the obligation and will be adjusted at 6-month intervals. Interest income or expense computed on an economic accrual basis will be

reported or deducted as under prior law (that is, when payment is made in the case of a cash method taxpayer or due in the case of an accrual method taxpayer).

The revised interest rates provided by the 1984 Act will not apply in the case of any debt instrument arising from the sale or exchange of a principal residence to the extent the purchase price does not exceed $250,000. To the extent the price exceeds this amount, a portion of the debt instrument will be subject to the higher safe harbor and imputed interest rates established by the Act. To the extent the purchase price does not exceed $250,000, the debt instrument will be subject to the revised rules of section 483 except that the safe harbor rate and imputed rate are 9 percent and 10 percent, respectively. Amended section 483 will also not apply to any sale or exchange of farmland. However, if the purchase price of farm exceeds $1 million, the debt instrument will be subject to the 110 percent minimum interest rate and the annual inclusion and deduction requirements of new section 1274. The Act retains the exceptions of prior law under which the section 483 rules do not apply to transactions where the sales price does not exceed $3,000 or to certain amounts constituting annuities under section 72. The Act also retains the rule under which the maximum imputed interest rate applicable to real estate transactions between related parties involving $500,000 or less is 7 percent (sec. 483(f)). The exception for sales of ordinary income property in prior law, however, was eliminated.

The Act also continues the exception under section 483 for the transfer of patents where payment is contingent upon the productivity, use, or disposition of the property transferred. A further exception to the unstated interest rules is provided for cash-method issuers (but not holders) of obligations issued in exchange for property substantially all of which will not be used by the issuer in a trade or business or held by the issuer for investment purposes.

The amendments to section 483 are generally effective for transactions occurring after December 31, 1984. However, in the case of sales or exchanges after March 1, 1984, a taxpayer may not rely on the literal terms of section 483 to claim a deduction for interest in amount in excess of that which is properly allocable to the period using a constant interest computation. Therefore, taxpayers in transactions subject to section 483 may no longer compute the portion of a payment constituting interest based on the size of the payment relative to the total payments due under the contract (see discussion at pages 8–9, supra).

IV. RECENTLY INTRODUCED LEGISLATION AFFECTING CODE SECTIONS 483 AND 1274

S. 2815—Senator Symms

On June 28, 1984, Senator Symms introduced a bill (S. 2815) that would repeal the changes made to section 483 by the Tax Reform Act of 1984. Thus, the bill would preserve the system whereby the section 483 safe harbor and imputed interest rates are established by regulation. The effect of the bill would also be to require that in transactions subject to section 483, the interest element of a payment be determined by the ratio of the payment to the total deferred payments due under the contract, as under prior law.

(Similar legislation has been introduced by Mr. Archer in the House of Representatives. H.R. 6021, in addition to repealing the amendments to section 483 made by the Act, would repeal section 1274 as enacted by the Act.)

S. 2815—Senator Melcher

On July 31, 1984, Senator Melcher introduced a bill (S. 2894) which would provide for reduced safe harbor and imputed interest rates for certain sales of residences, farms, or real property used in a trade or business. The maximum safe harbor and imputed interest rates for qualifying transactions would be 9 percent and 10 percent, respectively. Qualifying transactions would include a sale of a principal residence by an individual, a sale of a farm by an individual, estate, testamentary trust, or small business corporation (or by a partnership meeting certain requirements), or a sale by any person of real property used in a trade or business if the sale or exchange occurs in connection with the sale of the business. The maximum rates would apply only to the extent the stated principal amount of the debt instrument issued in the sale or exchange does not exceed qualified limits. The limits would be $250,000 in the case of sales of residences, $1,500,000 in the case of farm sales, and $500,000 in the case of sales of businesses. To the extent the purchase price of the property exceeded the specified limits, the limit would be the specified limit multiplied by a fraction, the numerator of which is the specified limit and the denominator of which is the purchase price.

S. 2894 would exclude a debt instrument arising from the sale of a farm or small business from the application of the provisions of new section 1274 to the extent of that portion of the instrument's principal amount not in excess of the applicable limit under section 483. The provisions of the bill would be effective as if included in the amendments made by the Tax Reform Act of 1984.

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Senator PACKWOOD. The hearing will come to order, please.

This is a hearing limited to the very narrow topic of imputed interest on the sale of real estate, and there are many of us in the Congress who think we made a mistake in the last tax bill in terms of how narrowly we drew the limitation on imputed interest. Hopefully, we will be able to undo that mistake.

I am going to start, if you are ready, Bill, with you today. There are a couple of Senators who wanted to come and testify but they are not here yet, and I would just as soon get started. If you are prepared, our first witness today will be Congressman Bill Archer from the State of Texas, who served on the Ways and Means Committee and I think he saw this mistake as we were making it.

STATEMENT OF HON. BILL ARCHER, U.S. REPRESENTATIVE, STATE OF TEXAS

Mr. ARCHER. Senator, thank you for this opportunity. I applaud the Senate for holding these hearings on a matter that I think can be very harmful to the best economic interests of this country, and that is the imputed interest provisions of the recently enacted Deficit Reduction Act of 1984.

At the outset I guess I should say that I wholeheartedly endorse the extensive and growing efforts to repeal these hastily-developed and poorly reasoned provisions. Toward that end, I have introduced H.R. 6021. Under this bill the new Internal Revenue Code section 1274 which extends the imputed interest concepts that have generally been applicable to certain debt instruments, to most debt instruments issued for property, would be repealed.

As a result, the provisions requiring taxpayers to currently accrue and deduct interest income at a required Federal rate, even if such taxpayers utilize the cash basis of accounting and are not paying such interest currently, would not apply to debt issued for property. And that's what we did in the tax bill recently enacted. We extended that to debt issued for property.

In addition, H.R. 2061 would repeal the modifications made by the act to section 483 of the code. These provisions of the act significantly increase the complexity associated with determining the applicable safe-harbor rate of interest which must be satisfied.

In short, my bill would return section 483 to its status prior to the act.

There are several extremely persuasive reasons why legislation to repeal these provisions along the lines of my bill should receive careful and immediate consideration. First, these provisions did not receive—by any stretch—the amount of consideration and analysis commensurate with their potential impact. The chaotic efforts associated with amending the concurrent resolution to provide a limited exception with respect to seller-financing of farms and personal residences shortly after the passage of the act are certainly evidence of the poorly conceived nature of these changes.

And I must say that I do applaud the Senate for making these changes in an attempt to try to rectify some of the problems that were created by the conference report.

Second, the impact which these provisions may have with respect to sales of farms and small business transactions will be particular-

ly acute. The new provisions impose a requirement that the parties to any sales transactions must specify 110 percent of one of three applicable Federal rates which will change every 6 months, or else be saddled with a penalty rate equal to 120 percent of the applicable Federal rate.

In addition, many taxpayers will be required to currently accrue the interest income involved, even though payment of the interest is not made currently. As a result, taxpayers literally will be incurring a current tax liability even though they will have no current income out of which to pay the tax. While such a system may have a degree of intellectual attractiveness to an economist secure in the confines of his office, the application of such a set of rules in the real marketplace in the everyday world is a far different matter.

Third, the rules of prior law to which my bill would return would provide the Secretary with sufficient authority to set the appropriate rate of interest.

Now, this has always existed in the law. I rather expect that the reason that the change was urged is that the Treasury did not want the responsibility of setting this rate. They have the authority to protect against any abuses.

It also represents a much fairer and more rational system whereby the Treasury could establish a single safe-harbor rate from time to time on which taxpayers could rely in structuring their transactions.

Some have observed that the prior law, section 483, did not permit Treasury to mandate a compound rate of interest, and it's possible that the Treasury may testify to you that they cannot protect against abuses because they don't currently have the power—did not currently have the power in the previous law—to mandate a compound rate of interest.

I would certainly be willing to consider as part of my legislation to return to old section 483 an amendment which would permit the Treasury to take into account compounding.

Fourth, the application of the newly-enacted imputed interest rules to seller financing of personal residences has several defects which dictate in favor of their repeal. The rate of interest mandated by the statute generally, even if the $250,000 exception is applicable, may actually exceed the arms-length interest rate agreed to by the parties; that is, the required rate fails to recognize the way in which houses frequently are bought and sold in the real market place. In addition, the effect of the newly-enacted provisions is to modify only the treatment of the seller's income when the safe-harbor interest rate is not satisfied.

Thus, while a portion of the payments from the buyer to the seller may be converted from an amount denominated principal into interest income which is taxable at ordinary income rates to the seller, no comparable modification is made with respect to the buyer to permit a larger home mortgage interest deduction. Such a result certainly does not square with the much heralded matching or consistency principle which we heard the Treasury advocate frequently in the context of various accounting and interest changes which the Congress was encouraged to enact in the context of the recent legislation.

Finally, the complexities associated with applying the hastily concocted $250,000 exemption where the sale price exceeds $250,000 are unnecessary and burdensome.

For all of the reasons noted above, I strongly urge this committee to favorably consider the various proposals like H.R. 6021 to repeal the imputed interest provisions of the 1984 act and return to the more rational world of old section 483.

[Mr. Archer's written testimony follows:]

STATEMENT OF THE HONORABLE BILL ARCHER
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGMENT
AUGUST 3, 1984

Mr. Chairman, Thank you for the opportunity to appear here today to testify concerning the various imputed interest provisions of the recently enacted Deficit Reduction Act of 1984. At the cutset, let me say that I wholeheartedly endorse the extensive and growing efforts to repeal these hastily developed and poorly reasoned provisions.

Towards that end, I have introduced H.R. 6021. Under my bill, new Internal Revenue Code section 1274, which extends the imputed interest concepts generally applicable to certain debt instruments to most debt instruments issued for property, would be repealed. As a result, the provisions requiring taxpayers to currently accrue and deduct interest income at a required federal rate, even if such taxpayers utilize the cash basis of accounting and are NOT paying such interest currently, would not apply to debt issued for property. In addition, H.R. 6021 would repeal the modifications made by the Act to section 483 of the Code. These provisions of the Act significantly increase the complexity associated with determining the applicable safe-harbor rate of interest which must be satisfied. The bill would return section 483 to its status prior to the Act.

THERE ARE SEVERAL EXTREMELY PERSUASIVE REASONS WHY LEGISLATION TO REPEAL THESE PROVISIONS ALONG THE LINES OF MY BILL SHOULD RECEIVE CAREFUL AND IMMEDIATE CONSIDERATION. FIRST, THESE PROVISIONS DID NOT RECEIVE, BY ANY STRETCH, THE AMOUNT OF CONSIDERATION AND ANALYSIS COMMENSURATE WITH THEIR POTENTIAL IMPACT. THE CHAOTIC EFFORTS ASSOCIATED WITH AMENDING THE CONCURRENT RESOLUTION TO PROVIDE A LIMITED EXCEPTION WITH RESPECT TO SELLER FINANCING OF FARMS AND PERSONAL RESIDENCES SHORTLY AFTER THE PASSAGE OF THE ACT ARE CERTAINLY EVIDENCE OF THE POORLY CONCEIVED NATURE OF THESE CHANGES.

SECOND, THE IMPACT WHICH THESE PROVISIONS MAY HAVE WITH RESPECT TO SALES OF FARMS AND SMALL BUSINESS TRANSACTIONS WILL BE PARTICULARLY ACUTE. THE NEW PROVISIONS IMPOSE A REQUIREMENT THAT THE PARTIES TO ANY SALES TRANSACTIONS MUST SPECIFY 110% OF ONE OF THREE APPLICABLE FEDERAL RATES WHICH WILL CHANGE EVERY SIX MONTHS OR ELSE BE SADDLED WITH A PENALTY RATE EQUAL TO 120% OF THE APPLICABLE FEDERAL RATE. IN ADDITION, MANY TAXPAYERS WILL BE REQUIRED TO CURRENTLY ACCRUE THE INTEREST INCOME INVOLVED EVEN THOUGH PAYMENT OF THE INTEREST IS NOT BEING MADE CURRENTLY. AS A RESULT, TAXPAYERS LITERALLY WILL BE INCURRING A CURRENT TAX LIABILITY EVEN THOUGH THEY WILL HAVE NO CURRENT INCOME WITH WHICH TO PAY THE TAX. WHILE SUCH A SYSTEM MAY HAVE A DEGREE OF INTELLECTUAL ATTRACTIVENESS TO AN ECONOMIST SECURE IN THE CONFINES OF HIS OFFICE, THE APPLICATION OF SUCH A SET OF RULES IN THE EVERYDAY WORLD IS A FAR DIFFERENT MATTER.

THIRD, THE RULES OF PRIOR LAW TO WHICH MY BILL WOULD RETURN PROVIDE THE TREASURY WITH SUFFICIENT AUTHORITY TO SET

THE APPROPRIATE RATE OF INTEREST. IT ALSO REPRESENTS A MUCH FAIRER AND MORE RATIONAL SYSTEM WHEREBY THE TREASURY COULD ESTABLISH A SINGLE SAFE-HARBOR RATE FROM TIME TO TIME ON WHICH TAXPAYERS COULD RELY IN STRUCTURING THEIR TRANSACTIONS. SOME HAVE OBSERVED THAT THE PRIOR LAW SECTION 483 DID NOT PERMIT TREASURY TO MANDATE A COMPOUND RATE OF INTEREST. I WOULD CERTAINLY BE WILLING TO CONSIDER AS PART OF THIS LEGISLATION TO RETURN TO OLD SECTION 483 AN AMENDMENT TO PERMIT SUCH COMPOUNDING.

FOURTH, THE APPLICATION OF THE NEWLY ENACTED IMPUTED INTEREST RULES TO SELLER FINANCING OF PERSONAL RESIDENCES HAS SEVERAL DEFECTS WHICH DICTATE IN FAVOR OF THEIR REPEAL. THE RATE OF INTEREST MANDATED BY THE STATUTE GENERALLY, EVEN IF THE $250,000 EXCEPTION IS APPLICABLE, MAY ACTUALLY EXCEED THE ARMS LENGTH INTEREST RATE AGREED TO BY THE PARTIES. THAT IS, THE REQUIRED RATE FAILS TO RECOGNIZE THE WAY IN WHICH HOUSES FREQUENTLY ARE BOUGHT AND SOLD IN THE MARKETPLACE. IN ADDITION, THE EFFECT OF THE NEWLY ENACTED PROVISIONS IS TO MODIFY ONLY THE TREATMENT OF THE SELLER'S INCOME WHEN THE SAFE-HARBOR INTEREST RATE IS NOT SATISFIED. THUS, WHILE A PORTION OF THE PAYMENTS FROM THE BUYER TO THE SELLER MAY BE CONVERTED FROM AN AMOUNT DENOMINATED PRINCIPAL INTO INTEREST INCOME WHICH IS TAXABLE AT ORDINARY INCOME RATES TO THE SELLER, NO COMPARABLE MODIFICATION IS MADE WITH RESPECT TO THE BUYER TO PERMIT A LARGER HOME MORTGAGE INTEREST DEDUCTION. SUCH A RESULT CERTAINLY DOES NOT SQUARE WITH THE MUCH HERALDED MATCHING OR CONSISTENCY PRINCIPLE WHICH WE HEARD THE TREASURY ADVOCATE FREQUENTLY IN THE CONTEXT OF VARIOUS ACCOUNTING AND INTEREST CHANGES WHICH THE CONGRESS WAS ENCOURAGED TO ENACT IN THE CONTEXT OF THE RECENT LEGISLATION. FINALLY, THE COMPLEXITIES

ASSOCIATED WITH APPLYING THE HASTILY CONCOCTED $250,000 EXEMPTION WHERE THE SALE PRICE EXCEEDS $250,000 ARE UNNECESSARY AND BURDENSOME.

FOR ALL OF THE REASONS NOTED ABOVE, I STRONGLY URGE THIS COMMITTEE TO FAVORABLY CONSIDER THE VARIOUS PROPOSALS LIKE H.R. 6021 TO REPEAL THE IMPUTED INTEREST PROVISIONS OF THE 1984 ACT AND TO RETURN TO THE MORE RATIONAL WORLD OF OLD SECTION 483.

Senator PACKWOOD. Bill, if we don't change this now, we're going to change it some day. This has all the potential of carryover basis. I can just see the welling up of opposition and irritation, and we might as well do it—as far as I'm concerned—sooner than later, because we are going to it later if we don't do it sooner.

I have no questions.

Bob?

Senator DOLE. I have no questions, except to thank Congressman Archer for raising this in the conference. I think you are the first one who may have detected it after the Wall Street Journal detected it. I want to thank the Wall Street Journal.

But in any event, I think we do have a problem here, and I hope Treasury is going to be able to shed some light on it instead of just passing the buck to us. The buck's gone. [Laughter.]

Senator DOLE. But it is something I think we are going to have to work out. We think we did help it some on the Senate floor. But I must say there are others who have a different view in the Senate, and there may be others who have a different view in the House.

What is happening on the House side?

Mr. ARCHER. Well, right now, Mr. Chairman, nothing is happening on the House side, but we hope to be able to use some leverage to create consideration in the Ways and Means Committee, also. Certainly if your committee acts, I think that that in itself will tend to pressure the House to take some type of action, too.

Senator DOLE. Of course, you know the problem on the Senate side. When you start acting on one provision around here, you end up with 500.

Mr. ARCHER. Yes.

Senator DOLE. And that is a real problem. It seems to me we are just asking for trouble to send out any little tax bill, unless we can do it late some afternoon when nobody is around—and we're keeping an eye on that.

Mr. ARCHER. Well, I appreciate your interest. And I want to restate very quickly that it is not my desire to open the door to abuses; but I think we can get hung up on some anecdotal comments about potential abuses and at the same time destroy the flow of the sale of property in this country, which we so desperately need. And particularly at a time when interest rates are rising and making it very difficult to sell property, and seller financing becomes an important tool.

I believe that if there are abuses, that the Treasury—if it is given the authority it had in section 483—can handle them, and particularly if the ability to construct a compounding interest requirement is also given to them.

And I thank the committee.

Senator PACKWOOD. Thank you, Bill, for coming.

Next we will take our colleague Senator John Melcher from Montana.

STATEMENT OF HON. JOHN MELCHER, U.S. SENATOR FROM THE STATE OF MONTANA

Senator MELCHER. First of all, good morning. I want to thank both you, Senator Packwood, the subcommittee chairman, and you,

Senator Dole, as the chairman, for having these hearings. We sure need them.

Senator PACKWOOD. Forgive us for putting the Congressman on first. We started right on time. He was here and you hadn't quite come in the door, so we went ahead and put him on.

Senator MELCHER. I appreciate your doing that, because I think often we wait too long around here for somebody to show up. I admire chairmen when they call the meeting to order and get on with the business.

I think it is a well-known fact that there is a sinful lust exhibited by the Internal Revenue Service to collect any taxes that they can, no matter whether they are justified or not, and particularly from ordinary business deals and ordinary people.

But really, there is no reason why Congress should abet that sinful lust of the Internal Revenue Service by passing legislation that allows them to exercise their ill-begotten desire for interfering in real estate transactions and for imposing, in particular, higher interest rates on seller financed sales.

Ever since 1979 I have had a big interest in this issue and have opposed the Internal Revenue Service efforts to establish higher and higher imputed interest rates on seller-financed sales. The fact that this provision, which would direct the Internal Revenue Service to impose 15 percent imputed interest on a great number of sales of seller-financed property in the country, is not a very good recommendation for either the executive branch or Congress.

I don't believe that people can understand just why that provision got into the bill and why the President signed it just a few days ago.

I think the logical answers are, first of all the President did not know or understand this section of the bill, and second I don't think that the majority in Congress understands what the term "imputed interest rate" means either. I hope before we get done here, in the next several weeks, everybody in Congress will understand it.

Third, I don't think the public has any real knowledge of this provision or any knowledge of the law that was there previous to that time regarding the imputed interest rates. I believe that before this session of Congress ends we will find a staggering amount of the Senate wanting to modify this provision rather drastically.

I hope the House concurs in it, and I think they will.

We have a bill introduced—I think 10 other Senators—that would modify it and put it back into some reasonable form.

If it is reflected upon that imputed interest has been a part of the Tax Code since 1964, we might wonder why more people don't understand this particular provision and come to the forefront in an attempt to either repeal it or to at least hold it down?

I think it is true that the importance of the imputed interest rates has grown rather dramatically in recent years because of the high commercial interest rates. And I think the combination of both high commercial rates and high imputed interest rates of the last tax bill in many cases will eliminate the last avenue that many people have to buy or sell property. And if the higher interest rates would go into effect the first of this year, the sales of

small businesses, many farms and ranches, and a great number of houses will come to a screeching halt.

I want to take just a moment to trace the developments that have brought us to this point.

In 1979, when the IRS issued the proposed new regulations: raising interest rates required in seller-financed deals from 6 percent to 9 percent, I contacted the IRS to oppose this change. There were 2,500 comments on the proposed regulations, all of them in the negative. But the IRS nevertheless issued new regulations increasing the rate to 9 percent.

In 1981, a group of us in the Senate introduced an amendment during the consideration of the 1981 Tax Act on the Senate floor. We would have barred the increase on imputed interest rates on sales and exchanges of real estate of less than $2 million. This was aimed at retaining the lower interest rates for farmers, and ranchers, and small business people.

Even though we approved the amendment by 100 to nothing, during the conference the unconscionable pressure put on the conferees by Secretary Regan caused that amendment to be watered down. Well, that was bad enough, but this tax bill with this provision in it was so bad that we amended it on June 29 before it could be signed by the President, and we changed it to where it is right now with provisions to go into effect in the beginning of 1985.

That means that on those sales of farm and ranch land under $1 million and sales of a principal residence of $250,000 or less, that the imputed interest as it stood prior to this act—and as it stands today, as a matter of fact—could be charged.

Well, I don't believe those two exemptions are adequate. They do not provide any relief to small businesses at all, or to most. It doesn't make any difference whether the filling station would be selling for $20,000 or $30,000 and it's seller financed; the IRS would have to impute an interest rate of 110 percent whatever the T-bill sales are. Right now it would be around 15 percent.

That's bad enough. I think all small business people readily understand that if they are going to sell their business they are probably going to have to find a buyer, then they are probably going to have to finance part of the sale or perhaps all of the sale.

As to the other exemption for principal residences, I think that clearly interferes with the sales of other homes that are not categorized by the IRS as principal residences and therefore it is an intrusion into an ordinary business transaction where the sale of a home, or a condo, or a business property, business buildings, would have to have either the imputed interest rate of 15 percent or perhaps forgo the sale. The latter is the most likely case, because they couldn't sell it with the rate of 15 percent.

Further, there is the real chance that under the provisions of the new act just signed into law a cliff exists whereby the sale of a farm or ranch land amounting to even one penny more than $1 million exemption, that the entire sale is subject to the higher imputed interest rates set in the 1984 Tax Act.

Personally, I would like to see the provisions in the code on imputed interest rates completely repealed. I don't believe they are necessary. But the Federal Government should not be telling the

private citizen what interest rates they must charge in connection with their own private-business deals.

But if that can't be done, we ought to at least take some minimal steps to assure that the changes in the 1984 Tax Act that require higher interest rates on seller-financed property sales do not kill off the only method available for buying and selling a great amount of the property that is going to be sold particularly in this period of increasing commercial interest rates.

It is really the farmer, or the rancher, or the business person who will lose their last opportunity to sell all or part of their property, and the buyers who are getting the chance to purchase that property who are the losers.

Persons looking to purchase such properties but who are disqualified by the high commercial rates will not be able to get a start. As I said earlier, I do not believe that the Federal Government should be in the business of dictating what interest rates must be in transactions between private individuals.

The current facts are that increasing interest rates required on seller-financed sales of property at this time when rising commercial interest rates are already killing off property sales would be a significant deterrent to real estate sales and seller-financed construction of homes, apartments, and business space.

Now, the cosponsors we have on the bill we have introduced are Senators Levin, Baucus, Sasser, DeConcini, Jepsen, Hatfield, Eagleton, Burdick, Boren, Randolph, and Nichols. The bill is numbered S. 2894, and here is what it would do:

The first $250,000 of the sale price for residential property sold by an individual would be exempt from Internal Revenue Service's higher imputed interest rates in the 9 percent that has been current for the last couple of years.

Second, the first $1.5 million of the sale price of farm or ranch property sold by an individual, estate, partnership, or small business corporation would also be exempt, as well as in the case of the sale of real property, small businesses, the first $500,000 of the sale price would be exempt.

Our legislation doesn't go as far as we would like. Over the past week, I have heard from numerous groups and individuals who have legitimate criticisms of the seller-financing provisions of the 1984 Tax Act that won't be corrected by our bill. But given the resistance of some Members of Congress, we must go as far as we can to ensure that these exemptions are proved before the new Tax Act provisions on seller financing go into effect on January 1, 1985.

I hope that this committee will act quickly to correct the terrible provisions on seller financing that is part of that Tax Act. In lieu of this, I and the other cosponsors of S. 2894 intend to offer this bill or something like it to the first appropriate vehicle in order to ensure a vote on this before the end of this session of Congress.

[Senator Melcher's written testimony follows:]

40-276 O—84——3

Statement of
Senator John Melcher

August 3, 1984

I AM PLEASED THAT THIS SUBCOMMITTEE IS MEETING TODAY HOPEFULLY TO RESURRECT COMMON SENSE AND DENY THE INTERNAL REVENUE SERVICE THE ILL-ADVISED TREATMENT OF SELLER FINANCING OF REAL PROPERTY SALES ENACTED IN THE 1984 TAX ACT.

SINCE 1979 I HAVE CAJOLED THE SENATE TO REPULSE THE OUTRAGEOUS LUST OF THE INTERNAL REVENUE SERVICE TO DRIVE UP THE INTEREST RATES REQUIRED ON SELLER-FINANCED SALES OF REAL PROPERTY. THERE IS ONLY ONE REASON WHY CONGRESS AND THE PUBLIC WOULD TOLERATE THE INCREASE ON IMPUTED INTEREST IN THE TAX BILL JUST SIGNED INTO LAW BY PRESIDENT REAGAN A FEW DAYS AGO:

#1 HE DID NOT KNOW ABOUT OR UNDERSTAND THIS SECTION OF THE BILL

#2 VERY FEW IN CONGRESS KNOW OR UNDERSTAND IT

#3 THE PUBLIC DOES NOT EVEN KNOW WHAT IT MEANS UNTIL IT CLOBBERS THEM.

ALTHOUGH IMPUTED INTEREST RATES HAVE BEEN PART OF THE TAX CODE SINCE 1964, THEIR IMPORTANCE HAS GROWN DRAMATICALLY IN RECENT YEARS BECAUSE OF THE HIGH COMMERCIAL INTEREST RATES. THE COMBINATION OF HIGH COMMERCIAL RATES AND THE HIGH IMPUTED INTEREST RATES OF THE LAST TAX BILL WILL ELIMINATE THE LAST AVENUE THAT MANY PEOPLE HAVE TO BUY OR SELL PROPERTY AND, IF THESE HIGHER INTEREST RATES GO INTO EFFECT, SALES OF SMALL BUSINESS, MANY FARMS AND RANCHES, AND A GREAT NUMBER OF HOUSES, WILL COME TO A HALT.

I WANT TO TAKE JUST A MOMENT TO TRACE THE DEVELOPMENTS THAT HAVE BROUGHT US TO THIS POINT. IN 1979, THE IRS ISSUED PROPOSED NEW REGULATIONS RAISING INTEREST RATES REQUIRED IN SELLER-FINANCED DEALS FROM 6 PERCENT TO 9 PERCENT. I CONTACTED THE IRS TO OPPOSE THIS CHANGE. HOWEVER, EVEN THOUGH THE IRS RECEIVED OVER 2,500 COMMENTS ON THE PROPOSED REGULATIONS, ALL OF THEM NEGATIVE, THEY ISSUED NEW REGULATIONS INCREASING THE REQUIRED RATE TO 9 PERCENT.

I AND SEVERAL OTHERS IN THE SENATE CONTINUED TO OPPOSE THIS CHANGE AS AN UNNEEDED DETERRENT TO THE SALE OF PROPERTY AT A TIME WHEN RISING COMMERCIAL MORTGAGE RATES WERE ALREADY SHUTTING DOWN THE REAL ESTATE MARKET. DURING THE CONSIDERATION OF THE 1981 TAX ACT, I OFFERED AN AMENDMENT BARRING THIS INCREASE IN IMPUTED INTEREST RATES ON SALES AND EXCHANGES OF REAL ESTATE OF LESS THAN $2 MILLION. THIS WAS AIMED AT RETAINING LOWER INTEREST RATES FOR FARMERS, RANCHERS AND SMALL BUSINESS PEOPLE. THE AMENDMENT WAS APPROVED BY THE SENATE ON A 100 TO 0 VOTE. UNFORTUNATELY, BECAUSE OF TREASURY SECRETARY REGAN'S UNCONSCIONABLE PRESSURE LOBBYING, THE CONFEREES BUCKLED UNDER AND WATERED THE AMENDMENT DOWN.

THE 1984 TAX BILL WENT WELL BEYOND ANYTHING PREVIOUSLY PROPOSED FOR TREATING SUCH DEFERRED PAYMENT PLANS FOR REAL PROPERTY SALES AND PURCHASES. BECAUSE OF THE DRACONIAN IMPACT OF THIS PROPOSAL, ON JUNE 29, 1984,

THE TAX ACT WAS AMENDED TO PERMIT CONTRACTS TO CONTINUE TO BE WRITTEN AT 9 PERCENT FOR SALES OF FARM AND RANCH LAND UNDER $1 MILLION AND FOR THE SALE OF PRINCIPAL RESIDENCES UNDER $250,000. I DO NOT BELIEVE THESE TWO EXEMPTIONS ARE ADEQUATE. THEY DO NOT PROVIDE ANY RELIEF TO SMALL BUSINESSES, MOST OF WHICH ARE SOLD USING SELLER FINANCING; THEY DO NOT PERMIT INDIVIDUALS TO SELL SECOND HOMES, LEGITIMATE RESIDENTIAL PROPERTY, EXCEPT AT PROHIBITIVE INTEREST RATES SPECIFIED BY TREASURY NOTE SALES WHICH ARE CURRENTLY 15% AND LIKELY TO GO HIGHER; AND THE FARM AND RANCH LAND PROPERTY LIMITS ARE TOO RESTRICTIVE, HALTING SELLER-FINANCED SALES THAT EXCEED $1 MILLION.

FURTHER, THERE IS A REAL CHANCE THAT, UNDER THE PROVISIONS OF THE TAX ACT JUST SIGNED INTO LAW, A "CLIFF" EXISTS WHEREBY IF A SALE OF FARM OR RANCH LAND AMOUNTS TO EVEN ONE CENT MORE THAN THE $1 MILLION EXEMPTION THEN THE ENTIRE SALE IS SUBJECT TO THE HIGHER INTEREST RATES SET IN THIS TAX ACT.

PERSONALLY, I WOULD LIKE TO SEE THE PROVISIONS RAISING IMPUTED INTEREST RATES COMPLETELY REPEALED. THE FEDERAL GOVERNMENT SHOULD NOT TELL PRIVATE CITIZENS WHAT INTEREST RATES THEY MUST CHARGE IN CONNECTION WITH THEIR OWN PRIVATE BUSINESS DEALS. BUT, IF THAT CAN'T BE DONE, WE OUGHT TO AT LEAST TAKE SOME MINIMUM STEPS TO ENSURE THAT THE CHANGES IN THE 1984 TAX ACT THAT REQUIRE HIGHER IMPUTED INTEREST RATES ON SELLER-FINANCED PROPERTY SALES DO NOT KILL OFF THE ONLY METHOD AVAILABLE FOR BUYING AND SELLING A GREAT AMOUNT OF PROPERTY DURING THIS PERIOD OF INCREASING COMMERCIAL INTEREST RATES.

IT IS THE FARMER, RANCHER, OR BUSINESS PERSON WHO WILL LOSE THEIR LAST OPPORTUNITY TO SELL PART OR ALL OF THEIR PROPERTY, AND THE BUYERS WHO ARE GETTING A CHANCE TO PURCHASE IT, WHO ARE THE LOSERS. THE PERSON LOOKING TO PURCHASE SUCH PROPERTIES, BUT WHO IS DISQUALIFIED BY THE HIGH COMMERCIAL INTEREST RATES, WILL NOT BE ABLE TO GET A START.

As I said earlier, I do not believe that the Federal Government should be in the business of dictating what interest rates must be in transactions between private individuals. The current facts are that increasing interest rates required on seller-financed sales of property, at this time when rising commercial interest rates are already killing off property sales, would be a significant deterrent to real estate sales and seller-financed construction of homes, apartments and business space.

I, along with Senators Levin, Baucus, Sasser, DeConcini, Jepsen, Hatfield, Eagleton, Burdick, Boren, Randolph and Nickles, have introduced S. 2894 to permit seller-financed contracts, sometimes known as contracts for deed, to continue to carry a 9 percent interest rate for:

(1) THE FIRST $250,000 OF THE SALE PRICE FOR RESIDENTIAL PROPERTY SOLD BY AN INDIVIDUAL;

(2) THE FIRST $1.5 MILLION OF THE SALE PRICE OF FARM OR RANCH PROPERTY SOLD BY AN INDIVIDUAL, ESTATE, PARTNERSHIP, OR SMALL BUSINESS CORPORATION; AND

(3) THE FIRST $500,000 OF THE SALE PRICE OF REAL PROPERTY ASSOCIATED WITH THE SALE OF A SMALL BUSINESS,

RATHER THAN THE HIGHER IMPUTED INTEREST RATES REQUIRED BY THE 1984 TAX ACT.

OUR LEGISLATION DOESN'T GO AS FAR AS WE WOULD LIKE. OVER THE PAST WEEK I HAVE HEARD FROM NUMEROUS GROUPS AND INDIVIDUALS WHO HAVE LEGITIMATE CRITICISMS OF THE SELLER FINANCING PROVISIONS OF THE 1984 TAX ACT THAT WON'T BE CORRECTED BY OUR LEGISLATION. BUT, GIVEN THE RESISTANCE OF

SOME MEMBERS OF CONGRESS, WE MUST GO AS FAR AS WE CAN TO ENSURE THAT THESE EXEMPTIONS ARE APPROVED BEFORE THE NEW TAX ACT PROVISIONS ON SELLER FINANCING GO INTO EFFECT ON JANUARY 1, 1985.

I HOPE THAT THE FINANCE COMMITTEE WILL ACT QUICKLY TO CORRECT THE TERRIBLE PROVISIONS ON SELLER FINANCING THAT ARE PART OF THE 1984 TAX ACT. IN LIEU OF THIS, I AND THE OTHER COSPONSORS OF S. 2894 INTEND TO OFFER THIS LEGISLATION TO THE FIRST APPROPRIATE VEHICLE IN ORDER TO ASSURE A VOTE ON THIS BEFORE THE END OF THIS SESSION OF CONGRESS.

Senator PACKWOOD. John, thank you. I agree with you, and I applaud your leadership. I have no questions.

Bob, do you have any?

Senator DOLE. I have no questions, but I again want to thank Senator Melcher for his determination in this area. I think we did make a step in the right direction, even though we got down to 53 members that day; it was getting pretty shaky. But we are going to try to figure out something, John, that will satisfy most of your concerns, and hopefully we will have the help of Treasury. I think they are willing; I think they understand that even though that was in the bill a long time—I am not faulting Treasury, nobody was hiding anything—suddenly it was discovered sort of after the conference. That amazes me; I don't know where everybody was during the interim.

So we are going to be trying to work out something. Our problem, as you know, is trying to bring out a little piece of legislation. That is pretty hard to do, because everybody has an idea that they ought to add to that little piece, and I don't know where we will end up.

But I appreciate your help on it.

Senator MELCHER. Thank you. I think maybe our tax bills, when they have to be hauled between the House and the Senate in cardboard boxes that have to be pushed along in those little carts with pretty strong muscles and backs, are too big.

Senator DOLE. Thirteen hundred and nine pages.

Senator MELCHER. And I think we have a lot of things in there that we are not too sure of the effect of. This is one of them.

Senator PACKWOOD. Chuck?

Senator GRASSLEY. I guess the only thing I would add is that I thought that in 1981 or 1982—I forget exactly which year it was—that you made a good case for the general subject when it first became an issue as a result of some rulings in 1979 or 1980. I thought we had that train out of the station and that we wouldn't have to go back through this again. So that's what kind of bothers me about the whole process. Maybe that's why it wasn't given the attention it should have been given in the first round, because people were off guard considering the fine work that you did earlier in this decade on that issue.

Senator MELCHER. I think the answer is, when you find something that is as sour and repulsive as the IRS imposing imputed interest rates, I think we ought to be very stringent on what authority we give them. As a matter of fact, in our 1981 action we did leave the door open for Treasury to make a decision that imputed interest rates should go up. Having left that door open, while they didn't exercise that authority for a number of years, I think they felt in 1984 they would have Congress pass it in statute form rather than exercising the authority they have.

At any rate, I am glad the issue is foursquare before us and that the public is beginning to be alert and aware of this authority granted by Congress to the Treasury Department. And I hope that we restrict their authority rather vigorously in whatever vehicle we pass this year. I'm sure we have plenty of votes in the Senate; I only hope there are a lot of votes in the House, too.

Senator DOLE. I don't disagree with that, but let's don't get too carried away; there is some reason for all of this, and there would be a lot of abuse of any provision if you didn't have any responsible rule or regulations. So while I am sympathetic to making some reasonable change, I'm not about to suggest we ought to just throw it all out and let everybody abuse the program.

Senator MELCHER. Well, I think the Treasury Department would make a better case for their views on the need for any law on this if they would simply, instead of conversation while you are considering one of these tax bills—out in the corridor, in the Vice President's room, or what have you—they would present a study showing where they think people have abused interest rates and therefore avoided some tax.

But I think the answer we got in 1981 out of the Joint Committee on Taxation—and I think to the best of our ability it was the only answer that Treasury could give us then—was that the whole question was really probably a wash, because when lower interest rates are charged the buyer doesn't have as large a deduction to take, and the seller of course has less income. And, vice versa, when higher interest rates are given, there is a greater deduction on the part of the buyer and of course more income on the part of the seller.

So I just fault the Treasury Department on this particular point: If they really believe that there are a lot of taxes being evaded this way, they ought to have the study to demonstrate that that indeed is true.

Senator PACKWOOD. John, thank you very much.

Senator MELCHER. Thank you very much.

Senator PACKWOOD. Next we will hear from Ronald Pearlman, the Acting Assistant Secretary for Tax Policy of the Department of the Treasury.

Welcome to this position, Ron.

STATEMENT OF RONALD A. PEARLMAN, ACTING ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. PEARLMAN. Thank you, Mr. Chairman, although I'm not sure this morning's is the best one to start off with.

Senator PACKWOOD. If I could add just a personal plea: In the past we of course have allowed the Treasury Department to testify at length, because usually we had numerous tax bills and you had to cover eight or nine of them. I hope you are not going to read the entire nine-page single-spaced statement to us.

Mr. PEARLMAN. I am not going to read it to you, Mr. Chairman. I think that is not a productive use of the time.

I would like, however, to touch on some of the highlights and I think, hopefully, focus the issues, at least as we see them, a bit better.

I appreciate being here; I appreciate the opportunity of giving you our views. As is probably not too much of a surprise to you, we are very supportive of the changes to both section 483 and the original discount rules that were enacted by the Congress in the

1984 act. They are consistent with provisions included in the administration's budget.

We think that the changes that were made during the legislative process were constructive ones, including those made late in the process.

I think I would like to echo Senator Dole's statement before, that clearly no one was trying to hide anything in terms of this process. It is unfortunate that this issue came up very late in the conference, but it was not by the malcontent of anyone, certainly, to my knowledge.

I think, to set the stage, it is important to go back and say that both the original issue discount rules and the imputed interest rules are not new to the tax law—they have been there for a number of years. The original issue discount rules have been there since 1969, and the imputed interest rules since 1964. Congress has struggled with those rules previously. Congress, I think, recognizes the fact that taxpayers, if left without guidance, are able to simple manipulate the creation of and the reporting of interest in a manner which distorts what otherwise would be viewed as an economically accurate transaction.

Senator PACKWOOD. But, Ron, isn't there a way—we all know what we are trying to allow and what we are trying to stop. And what you are trying to allow is the perfectly decent farmer or homeowner that is having difficulty selling their property and is not trying to abuse the Government by skewing the interest down and the capital value up. Is there not a way to take care of that problem?

Mr. PEARLMAN. Well, Mr. Chairman, let me identify the problems as I see them and then let me try to address your question.

There are basically three problems that are dealt with by these provisions. One is, what is the proper amount of interest, the correct rate of interest, in a transaction when the taxpayers—well let's take the easy case—don't identify an interest rate; or, in a little more sophisticated case, when they identify a very low rate of interest that we would all agree is lower than market value. That's question No. 1 and that is one of the issues that was dealt with in 483 over the years and has involved the periodic efforts to adjust the 483 rate and is presented in both 483 and in 1274 by the new law. That's question No. 1.

Question No. 2 is, once you have identified that interest rate, when is the interest appropriately includable by the recipient of the interest and deductible by the payor? And here we get principally into the tax shelter problem of the mismatch of interest income and interest expense.

And third, and I guess closely related to the other two, is how should interest once identified be reflected accurately by both parties to the transaction and how should it be apportioned during the period of indebtedness?

What we have found is that interest is not apportioned in many transactions—and, again, in many tax shelter transactions—in an economically accurate way; but, instead, that interest is distorted by moving interest expense to the most advantageous time within a payment schedule.

Now, let's take the residence. Let's take the seller of a home or of a farm and say, why should we impose rules that impede that transaction? We reacted to that by saying that, in the case of the smaller farm and of the personal residence, there is less mismatching of interest and expense and misallocating of interest expense within the taxable periods. That is, for example, in the sale of a personal residence, there is less of a likelihood that an understatement of interest—well, there is probably no likelihood—that an understatement of interest is going to permit an increase in the principal amount of the residence and therefore create a depreciable basis in property which will result in an overstatement of depreciation and investment tax credit deductions.

So, we focused, therefore, on trying to get those transactions out of the original-issue discount rules, because those rules do require the matching of income and expense and do require a greater degree of complexity in the calculation than do the traditional 483 rules.

So I would respond to your question first by saying we think that the bill, by excluding those transactions—all principal residences and farms up to $1 million—from the original-issue discount rules we do put those sales in a context in which they can proceed without the tax law, if you will, encroaching on the efficiency of those transactions.

Now, the second part of the question, I think, is: What about the interest rate? What about the amount of the interest rate itself? And, if you require the imputation of a higher interest rate, won't that impede sales?

I think that this, in my judgment, is the most misunderstood aspect of these two provisions, and indeed the most misunderstood aspect of section 483, the imputed interest rules, before their recent amendments.

These rules do not at all—not at all—affect the number of dollars that a buyer and seller can agree will pass hands in a transaction. If a buyer and seller want to conclude that over a period of 10 years a piece of property is going to cost the purchaser $100,000 or $500,000, these rules don't affect that at all. What they say is, once the buyer and seller determine the amount of dollars that are going to pass hands in the transaction, then the tax law can properly, legitimately say, "All right, now let's see how those dollars should be characterized." Simply because a buyer and seller agree that a very low portion of those dollars should be characterized as interest is inconsistent with the traditional notion that the tax law should be able, once the taxpayers establish the economics of their transaction, to say, "Wait a minute. We won't disturb the total dollars involved, but we are going to second guess whether you are accurate, whether you are economically accurate, when you identify the portion of those dollars that are interest income or interest expense." And only by permitting the tax law to do that do we bring any real economic reality to that transaction.

In those transactions in which we say that a lower rate of interest—in favored transactions, as in our original budget proposals—should be available in those transactions, we are distorting the economics of that transaction, and we are distorting the accuracy of the tax reporting of that transaction.

We concluded that there were certain transactions that we were prepared to do that with, simply because they were not the disturbing kinds of transactions that our legislation was directed to.

But that requires drawing lines. So what we basically are saying is, we think the lines that have been drawn, both within the original-issue discount rules that are contained in the new law and in the 483 imputed-interest rules, are lines that sensibly make a distinction between potentially large transactions which can create a material, significant income tax distortion and those transactions which do not create that material potential, in which we say even though they are distortive we are prepared to live with that.

Now, if you say to me, "Well, could the line be drawn somewhere else?"—certainly the line could be drawn somewhere else. There is no magic to a $250,000 number or a $500,000 number, or a $1 million number. But I think we have to recognize that when we do that, when we change those rules, if we raise thresholds, all we are doing—we are not changing at all what buyers and sellers are going to agree to pass totally in a transaction; we are not changing what people say they are really doing to pay for property—all we are doing is saying we are going to give a tax break to it. And we just have to be prepared for that.

Senator DOLE. Could I ask a question? Treasury had the authority to change all of this, didn't they? Without us doing it? Why did you give us the ball? Doesn't Don Regan like high interest rates? [Laughter.]

Mr. PEARLMAN. I don't think it is fair to say we passed the ball. I think that beginning several years ago, I think in ERTA, there was clear recognition that interest rates as they relate to the Internal Revenue Code—I am thinking specifically of rates on tax deficiencies—were not, through delay in the administrative process or the politics that get involved when rates are adjusted, were not being adjusted either upward or downward to keep abreast of real market interest rates.

So Congress decided—again, I think it was in 1981—to key the tax rate on deficiencies to an automatically adjusting rate, so that they would just change every 6 months. And I think taxpayers and the Internal Revenue Service were well served by that change. I think that's the way we perceive this change.

Had the Internal Revenue Service, for example, changed the imputed interest rates 3 years ago when rates were 20 percent, and had gone through the controversy that that would have produced, and had that rate stayed up there for a year or 1½ years because of the inherent delay in the process of making that change, people would have been screaming and yelling—"Why hasn't the Internal Revenue Service changed that rate? Why has it taken so long for regulations to change that rate?"

We think that the way this bill operates, that just says every 6 months we are going to look at that rate, "If the rate goes up, it goes up; if it goes down, it goes down" is not a buck-passing effort; it's an effort to say let's try to keep the rates as reasonably current as we possibly can, to everyone's benefit.

Senator DOLE. What about the costs of this provision? How much revenue?

Mr. PEARLMAN. I am glad you asked that question, Mr. Chairman.

Senator DOLE. Is it a big problem, or a small problem?

Mr. PEARLMAN. Well, I may not be able to answer part of the question, but let me give you some numbers and then I may have to give you additional information.

Let me preface it by one statement, because I want to make clear that the statement is made on behalf of Treasury.

We would oppose as strongly as we possibly could any effort to repeal the original-issue discount rules, the 1274 rules or the 483 rules, in their entirety. We think that would be not only a revenue disaster but a disaster in terms of trying to bring some economic sensibility to the tax system.

The provisions that were contained in the Deficit Reduction Act—that is, the change in the interest rate and the provisions that were designed to match payor and payee and try to give some accuracy to the time at which interest income is included or deducted—produced very substantial revenues. For the 1985 to 1987 period, the number is $2.2 billion, and during the 1985 to 1989 period the dollar amount is $6.3 billion. So, even if a legislative effort were undertaken to return to prior law, we're talking about very substantial revenue dollars. And let's face it, in developing our proposals, the revenue impact of these proposals had a major impact on us coming to the Congress and saying we thought we needed to make a change in this area. We not only in general identified this problem earlier, but I would point to the testimony given in June of 1983 before Senator Grassley's Oversight Committee, when we, with some specificity, came to the committee and said, "Gentlemen, we have a problem with original-issue discount and imputed interest," and we laid out the problem. And we laid out what we thought the solutions were. Those solutions were no different from the ones we proposed in February of 1984 in the administration budget.

Subsequent to that, we presented to the staff of the Joint Committee boxloads of tax-shelter offering memoranda showing how the imputed interest rules and the original-issue discount rules were being used by taxpayers to gain advantage in the system. So we are talking about provisions that have been used for extremely abusive transactions, provisions that prior to change became institutionalized into routine business transactions but at a very substantial revenue cost.

Well, I'm prepared to stop if you'll let me make one small comment, and that is, I would like to react a bit more specifically to what was done at the end of the session and the efforts that are being undertaken here.

We recognized, as I indicated to you, that when we submitted our original budget proposals that there was a desire to exclude certain transactions that were relatively small in dollar amount and relatively routine from the original-issue discount rules. We also made no effort to change the more favorable interest rates, imputed rates, that are accorded to certain transactions under current law in section 483.

At the end of the session, we recognized that the changes that were made by the Congress expanded the number of transactions

that would create a tax distortion, but we also recognized there was some sensibility in doing that.

So we are not here today second-guessing that or criticizing that. We are here today saying to you we believe that the lines that were drawn, albeit arbitrarily, are sensible lines, that they define sensible categories of transactions both in terms of types of transactions—residences and farmland—and dollar amount. And we do not support trying to increase those dollar amounts or expand those categories.

Hopefully, as always, Mr. Chairman, as the committee thinks out these issues and deals with these issues, Treasury will work with you and hopefully be able to cooperate with you and try to be supportive.

Thank you.

Senator DOLE. As I understand, you have a different feeling about a principal residence, maybe even a second residence, and farm property. You have a different feeling about business property—is that correct?—because it is a depreciable asset and all that?

Mr. PEARLMAN. That's correct. We think the principal residence is a sympathetic case, and that's how we try to deal with it.

Senator DOLE. Well, as I understand it, it may be harder to dispose of the second residence than it is the first.

Mr. PEARLMAN. Well, I think the issue, it seems to me, with other than the principal residence, Senator Dole, though——

Senator DOLE. That's the point I wanted to make.

Mr. PEARLMAN. Oh, I'm sorry. Excuse me.

Senator DOLE. I guess the point is, you went along with the changes in June because you could justify those, but you had a problem. Senator Melcher raised the question about a little service station in Green River—I can't remember the place; I've got all those withholding notices.

Senator DOLE. But he found a different view there. I was just wondering what you thought about that.

Mr. PEARLMAN. There is another exception in the original-discount rules that I don't think we should ignore, and that is the one that says transactions where total payments are less than $250,000 are also excluded from those rules. I would presume that Senator Melcher's $30,000 filling station, which he has used as an example, would be excluded from the original-issue discount rules as a result of the $250,000-or-less exclusion.

We get back to the question, which I think is the one that people are focusing on, and that is, because we use a higher imputed rate it's going to impede the sale of property. And we simply don't buy that. We think that's a misunderstanding. If I want to sell my property, and you come to me and say, "I'm willing to pay you $100,000 for that property but I'll only pay you 3 percent interest," if I use my head and I know that I can reinvest money at 13 percent—as it was this morning if I bought a 2-year CD—I know I'm not getting $100,000 for my property if I sell it to you on a 3-percent note over the next 10 years. People know that.

And what we are saying is, you set the price. We don't care what price people set. But once you set the price, then it's unfair for taxpayers to be able to say, "And we'll now choose what portion of that price is interest and what portion of that price is principal"

because that's where the abuse of the tax system comes in. And I don't share the view that we are going to impede sales. People understand that if they sell at a discounted interest rate, it has an economic cost to them. They understand it today, and they will understand it 2 years from now.

The thing that is going to impede sales is that people aren't out in the market, not what portion of the sales price is interest and what part is principal.

Senator PACKWOOD. Chuck?

Senator GRASSLEY. No questions, Mr. Chairman.

Senator PACKWOOD. John?

Senator CHAFEE. Well, I agree with the Secretary. I don't see what all the fuss is about here. I look forward to hearing some of these witnesses. I wish I could stay to hear them all because I am interested to hear what the counterarguments are.

Thank you.

Mr. PEARLMAN. I appreciate that.

Senator PACKWOOD. Senator Long?

Senator LONG. I find myself thinking about what happened to a lady who wanted to sell her home. She was determined to get her price for the house, and so the prospective purchaser negotiated and said he would pay her price, but she would have to let him pay it off over a period of time at a very low interest rate. So she made the deal on that basis. I think any banker would have told her that actually the price she was getting on those terms was a lot less than she had been asking for. She thought, in principle, she was getting her asking price, but in fact she was losing a ton of money in interest. So what someone pays in interest would amount to a gift if the interest rate is a great deal lower than prevailing interest rates. I take it that's the point you are working on in Treasury.

Now, how do you suggest doing that? Let's say you think people could get 10 percent interest on their money with a certificate of deposit, but they make a sale at 3 percent. How do you propose to handle it?

Mr. PEARLMAN. Well, the law sets a so-called test rate. Indeed, a test rate has been in the law under section 483 since 1964. The law sets a test rate, the rate now set is a self-adjusting rate—every 6 months. It keys off what is called the "Federal rate" and depends on the length of the obligation—a short, medium, or long-term Treasury obligation. The test rate is 110 percent of whatever that Treasury rate is.

Now, the reason that rate was chosen was because that is likely the lowest rate that someone conceivably could borrow, notwithstanding their credit rating. That is, we wanted to be conservative and not go to a commercial bank and look at what bank rates are; they are going to be a lot higher than 110 percent of the Federal rate. You identify the Federal rate and, just to answer your question quickly, you simply compare the rate that was stated by the taxpayer. If it's under 110 percent of the Federal rate, the rate that would be imputed is 120 percent of that rate.

Now, depending on how the transaction is structured, that calculation can become more or less sophisticated; but, essentially, that's the way these rules operate.

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Let me also point out that in any transaction in which interest is stated at that Federal rate, there is no problem with these rules. You don't have to worry about the original-issue discount rules; all you have to do is state the rate and pay it currently. So in those transactions there is no problem with these rules. And in my experience, at least in my 15 years of practice, there were few transactions in which people didn't pay at least interest currently. It was not unusual to see transactions in which only interest was paid for some period of time, but I would submit to you it is an unusual transaction when a seller agrees to take nothing for a long period of time. And indeed where we have seen that is in the tax shelter transaction.

Senator PACKWOOD. John?

Senator CHAFEE. Well, Mr. Chairman, all I can say is that at home the folks in Rhode Island may not know the name of the President of France or the Prime Minister of Ceylon, but they sure know what they are doing with their money. When they sell something and the buyer wants to pay for it over a period of time, they know exactly what they should get in interest. They follow these things pretty closely.

So I am waiting for the counterarguments here.

Senator PACKWOOD. Ron, thank you.

Mr. PEARLMAN. Thank you, Mr. Chairman.

Senator PACKWOOD. We will conclude with a panel of Donald Treadwell, John Koelemij, and Harry Deines accompanied by Hover Lentz.

Senator DOLE. Mr. Chairman, while they are coming up I wonder if I could ask if a statement by Senator Jepsen be made a part of the record, and also a statement by Senator Symms.

Senator PACKWOOD. They may be made a part of the record, and I also have a statement to insert from the National Federation of Independent Business and from the National Multihousing Council.

Senator DOLE. Senator Jepsen may be here, and so may Senator Symms.

Senator LONG. I would like to ask that Senator Pryor's statement be included in the record at this point, Mr. Chairman.

[The prepared statements of Mr. Pearlman, Senators Pryor and Jepsen, the National Federation of Independent Business, and the National Multihousing Council follow:]

For Release Upon Delivery
Expected at 10:00 a.m., E.S.T.
August 3, 1984

STATEMENT OF
RONALD A. PEARLMAN
ACTING ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department regarding the impact of the recent amendments governing the application of the original issue discount and imputed interest rules to sales of residences (other than principal residences), farmland and real estate associated with small businesses. The Treasury Department believes that the principles underlying the rules adopted as part of the Tax Reform Act of 1984 provide the proper tax treatment of seller-financed sales and exchanges of property.

I

BACKGROUND

To evaluate the impact of the changes made to the original issue discount and imputed interest rules by the Tax Reform Act of 1984 (the "1984 Act"), it is important to understand both the rules which existed prior to the 1984 Act and the tax policy basis for both the original rules and the recent amendments.

1. Rules Prior to the 1984 Act

Under prior law, a holder of a publicly traded obligation or an obligation issued for publicly traded property was required to include original issue discount in income over the term of the obligation, irrespective of whether the holder employed the cash or the accrual method of accounting for other items of income and deduction. An issuer of an original issue discount obligation similarly was permitted to deduct the discount as it accrued over time. This treatment of original issue discount is based on two premises. First, the rules recognize that original issue discount represents interest that has accrued, but has not been paid, during the term of the obligation; and that this accrual is the economic equivalent of the borrower paying the interest annually and borrowing it from the lender. Second, as early as 1969, it was deemed necessary to place both the issuer and holder of an original issue discount obligation on the accrual method with respect to the interest inherent in the obligation in order to ensure consistent accounting between the parties to the transaction. In the absence of such a rule, there existed a substantial potential for mismatching of the timing for income and deductions, with attendant revenue loss.

Prior to the 1984 Act amendments, the original issue discount rules did not apply to obligations issued in exchange for non-publicly traded property. Thus, transactions involving the purchase of real estate or non-publicly traded personal property in which there was seller financing generally were outside the scope of the original issue discount rules even if the financing permitted interest to accrue without being paid currently.

Deferred payment obligations issued in exchange for non-publicly traded property were, however, subject to the imputed interest rules of section 483 of the Internal Revenue Code. Section 483 required that a minimum amount of interest be stated in the transaction (under prior law, 9 percent simple interest) or interest would be imputed at a higher rate (10 percent compounded semiannually). Section 483 provided a maximum test rate of 6 percent and an imputation rate of 7 percent for related party real estate transactions involving $500,000 or less.

2. Reasons for Change

Original Issue Discount Rules

Under prior law, the original issue discount rules generally did not apply to obligations issued in connection with the purchase of real estate or non-publicly traded personal property

(such as machinery). In these situations, tax avoidance opportunities resulted from the fact that transactions could be structured in which interest would accrue each year, but would not be paid until maturity. The issuer of the discount obligation (i.e., the purchaser of the property) typically would use the accrual method of accounting and appears to have been able to claim annual interest deductions over the life of the obligation. The holder of the obligation (i.e., the seller of the property) typically would use the cash method of accounting and defer inclusion of the discount in income until the obligation was paid at maturity.

The ability to mismatch the income and deduction for original issue discount in this manner formed the basis for numerous real estate and other tax shelter offerings. The revenue loss from these tax shelter offerings was significant and increasing dramatically as this structuring technique became known and used widely in transactions involving seller-financing. An example illustrates the magnitude of the revenue loss from a typical transaction: a $20 million obligation bearing interest at 12.5 percent per year and payable in a lump sum after 20 years might be given in exchange for property. An accrual method obligor in the 50 percent tax bracket would claim interest deductions over the term of the obligation having a present value of $22.2 million. Because the cash method obligee would defer recognition of interest income until payment of the obligation at maturity, the present value of the tax paid by the obligee in the 50 percent tax bracket is $9.1 million. Thus, the revenue loss to the government from one $20 million transaction is approximately $13.1 million on a present value basis.

In addition to the asymmetrical treatment of issuers and holders, original issue discount obligations issued in tax shelter transactions of the type described above frequently embodied a non-economic computation of interest (e.g., simple interest payable on a deferred basis). Both computations accelerate interest deductions by improperly identifying the period to which the interest charge is allocable. Cash method holders of the obligations are, of course, indifferent to these timing concerns because they defer the income inclusion until maturity. Although Rev. Rul. 83-84, 1983-1 C.B. 97, largely proscribed the use of non-economic interest calculations, we understand that several tax shelter offerings made prior to the enactment of the 1984 Act took positions inconsistent with this ruling.

Section 483

The tax law provides for different treatment of interest and principal of debt obligations given in exchange for property, as well as for items that are determined by reference to the

principal amount of such obligations, such as the seller's amount realized and the buyer's tax basis in the acquired property. Section 483 originally was enacted to ensure that, within broad limits, parties properly characterize as interest or principal amounts paid pursuant to obligations given in exchange for property. Without interest imputation rules such as those provided in section 483, whenever a debt obligation is given in exchange for property, the parties would have the flexibility to adjust the rate of interest charged and the principal amount of the obligation so as to produce an optimal tax result without altering the underlying economic transaction. The section 483 rules thus were intended to prevent parties to a transaction from artificially understating interest and overstating the principal of an obligation given in exchange for property. If these distortions were permitted, a seller could convert ordinary interest income into capital gain (taxable on a deferred basis under the installment sale rules) or gain that might be deferred indefinitely where a residence is sold. In the case of a buyer, the tax basis of the acquired asset would be overstated and excess accelerated cost recovery ("ACRS") allowances and investment tax credits ("ITC") would be claimed.

Section 483 is designed to prevent parties to a deferred payment sale transaction from improperly characterizing deferred payments by judging the adequacy of stated interest against a test rate. To the extent that the test rate provided under section 483 is less than a market rate of interest, the buyer and seller can improperly characterize a portion of deferred payments as principal and understate their tax liability. Thus, a below-market interest test rate effectively provides a tax subsidy for seller-financed sales of property.

This tax advantage is never available where a third-party lender finances the purchase of property. In such cases, the interest rate for the borrowing and the purchase price for the property are independently fixed at an arm's length rate and price.

Historically, the section 483 test rates have been adjusted only infrequently, and have often been at rates considerably below market interest rates. In the last few years, we became aware of a substantial -- and rapidly increasing -- number of transactions that exploited the below-market interest test rate and the noneconomic simple interest computation provided under section 483. In one case brought to our attention, a tax basis of more than five times the established fair market value of the property was claimed. Under a proper economic analysis, the "excess basis" -- i.e., the amounts payable under the obligation in excess of the fair market value of the acquired property -- represents interest and should be deductible only as it accrues

over the life of the obligation. However, by virtue of the defective operation of section 483, taxpayers claimed that the excess was transformed into inflated ITC and ACRS allowances which had a materially higher present value than the interest deductions.

3. Tax Reform Act Changes

These abuses prompted the Administration to propose a number of changes to section 483 and the original issue discount rules. These proposed changes were adopted as part of the 1984 Act.

New Section 1274 Rules

The 1984 Act expands the scope of obligations subject to the original issue discount rules. After December 31, 1984, obligations issued for non-publicly traded property are subject to the original issue discount rules. These new rules are contained in section 1274 of the Code.

For transactions involving deferred payments for the sale of non-pubicly traded property, the 1984 Act establishes safe harbor interest rates to test whether the obligation states adequate interest. If the parties to a sale or exchange of non-publicly traded property involving deferred payments fail to state adequate interest, interest is imputed at a higher rate. The safe harbor test rate is 110 percent of the "applicable federal rate" and the rate at which interest is imputed is 120 percent of the applicable federal rate. The applicable federal rate is based on average market yields on outstanding Treasury obligations of comparable maturity. The Treasury is to determine the rates for Treasury obligations with maturities of 3 years or less, over 3 years but less than 9 years and over 9 years. To ensure that the prescribed rates reflect market interest rates on an ongoing basis, the rates are adjusted at 6 month intervals. The rate in effect at the time a transaction is entered into will continue to govern the transaction regardless of later changes in the prescribed rate.

The new section 1274 rules thus embody two concepts: (i) original issue discount rules requiring the parties to take into account, on the accrual method of accounting, imputed interest (where adequate interest is not stated) or accruing interest (where adequate interest is stated, but is not paid currently) and (ii) an imputed interest test rate based on a structure designed to approximate a market rate of interest. The rule of (ii) reflects the policy of section 483 as in effect prior to the 1984 Act, but with a test rate that more nearly approximates a market rate of interest.

The new law provides exceptions to section 1274 for certain types of transactions. Thus, sales of principal residences, certain sales of farms for less than $1 million and any sales involving total payments of $250,000 or less are exempt from the expanded original issue discount rules. In these cases, the need to obtain uniform accounting for interest income and interest deductions was counterbalanced by a desire to simplify the tax treatment of these routine transactions.

Changes to Section 483

Section 483 will continue to apply to deferred payment transactions involving sales or exchanges of property that fall within one of the exceptions to the original issue discount rules of section 1274. The existence of unstated interest in these transactions will be tested with reference to the applicable federal rates established under section 1274. Where imputed interest arises in a section 483 transaction, however, as under prior law, it will be taken into account only as payments are made (rather than under an accrual method, as provided in section 1274). Thus, under section 483, payments are characterized as interest to the extent that imputed interest has accrued up to the time of payment.

In cases involving the sale or exchange of a principal residence (to the extent of the first $250,00 of the cost of the residence), or farmland costing less than the $1 million, the imputed interest test rate previously provided under section 483 -- rather than the new test rate of 110 percent of the applicable federal rate -- will apply. Thus, in the two cases specified, the existence of unstated interest will be determined by reference to the 9 percent test rate currently in effect. There is no intention at this time to adjust the 9 percent interest rate that is currently provided.

II

PROPOSED MODIFICATIONS

During final consideration of the 1984 Act, a number of questions were raised regarding the impact of the changes described above on sales of residences (other than principal residences), farmland and real estate associated with small businesses. Concerns were expressed that the changes made by the 1984 Act would render sales of these types of property more

difficult because the changes would require sellers utilizing purchase money financing to charge higher interest rates, would institutionalize such higher interest rates and would depress the real estate industry. Unfortunately, it appears that these concerns arise from a misunderstanding of the operation of these rules.

Many people erroneously assume that the imputed interest rules require purchasers to pay greater amounts for property or greater amounts of interest on seller-provided financing. Neither assumption is correct. The imputed interest rules affect only the characterization of amounts payable under deferred payment obligations as principal or interest for Federal tax purposes.

The section 1274 rules refine the imputed interest rules of prior law to require that taxpayers (i) allocate imputed interest to the periods to which it relates and take the interest into account for that period and (ii) determine whether adequate interest is stated in a contract for the sale of property by testing against interest rates which more closely approximate market interest rates. Taken together, these changes provide for the proper economic treatment of deferred payment obligations arising in connection with the sale or exchange of property. Stated differently, these rules conform the tax treatment of persons who utilize seller financing to the tax treatment of persons who finance the purchase of property with financing provided by a third-party and invest the sale proceeds with a borrower of the credit stature of the puchaser. The new rules will largely prevent the abuses described above, including mismatching of income and deduction, overstatement of tax basis and ITC and ACRS allowances and the conversion of ordinary income into capital gain taxed on a deferred basis.

The test rates established under the 1984 Act represent a far more realistic approximation of market interest rates than the rate provided under prior law. Some persons have asserted that a rate keyed to 110 percent of the yield on federal obligations of comparable maturity is excessive, because many taxpayers invest funds in bank accounts or otherwise, and obtain a yield that is less than 110 percent of the applicable federal rate. The flaw in this analysis is that the "loan" in a deferred payment sale is to the purchaser of the property -- virtually always a person with a weaker credit standing than a bank or the U.S. government. Taking into account this risk factor, a rate fixed at 110 percent of the rate of federal obligations of comparable maturity is a conservative estimate of the lowest market rate that the seller and buyer would set in a loan entered into independently of the sale transaction.

To illustrate, the applicable federal rates for the current period (July 1, 1984 to December 3, 1984) are approximately 10-1/4 percent (for short-term obligations), 11-1/2 percent (for mid-term obligations, and 12 percent (for long-term obligations). Thus, 110 percent of the applicable federal rates currently are approximately 11-1/4 percent, 12-3/4 percent and 13-1/4 percent, respectively. While yields on Treasury instruments today could imply somewhat higher rates for the future, we note that banks are currently offering long-term, fixed-rate home mortgage loans at approximately 15 percent.

Several exceptions to the section 1274 rules were provided in order to simplify the tax treatment of transactions where relatively unsophisticated taxpayers are likely to be involved without the assistance of informed professional advisors. Thus, sales of principal residences, certain sales of farms costing ~~less~~ than $1 million or less and sales involving total payments of $250,000 or less are not subject to section 1274. These exceptions were not provided because the principles underlying the original issue discount rules are not equally applicable to these transactions.

During final consideration of the 1984 Act, certain transactions involving principal residences and farmland -- which, in general, had previously been exempted from the new section 1274 rules -- also were exempted from the new imputed interest test rates provided under section 483. Thus, sales or exchanges of principal residences (to the extent of the first $250,000 of the purchase price) and certain farms costing less than $1 million were made subject to the imputed interest test rate under section 483 which existed prior to the enactment of the 1984 Act (i.e., 9 percent).

We question the wisdom of exempting classes of transactions from the revised imputed interest test rates provided by the 1984 Act. The changes to the imputed interest test rates under section 483 do not impose any greater administrative burden on taxpayers, but rather bring the provision in step with market reality by requiring taxpayers to test the adequacy of stated interest against a rate representing a conservative estimate of a true market rate of interest. As noted, the effect of these changes is to place the parties to a deferred payment sale transaction on the same footing for tax purposes as persons who purchase property with funds borrowed from a third-party lender and loan the sale proceeds to a third-party borrower.

We recognize that the changes to section 483 will in some cases affect the structuring of seller-financed sales of property. Sellers frequently have provided below-market financing to induce buyers to enter into transactions. As

demonstrated above, however, it is clear that in each instance in which a deferred payment transaction provides for a below-market interest rate, the liability for tax of both buyer and seller is potentially understated. The effect of the revised test rate structure may in some cases be to suggest to sellers that the price for their property is not what they might have desired. In cases where a below market interest rate is provided, however, we believe it is entirely appropriate to tax the parties to the transaction in accordance with true economic substance of the transaction, i.e., as involving a true market interest rate and a smaller sale price. This approach is fully consistent with the governing principle that the substance of a transaction, rather than its form, is controlling for Federal tax purposes.

III

CONCLUSION

First, we believe that the exceptions currently provided to the original issue discount rules of section 1274 -- for sales of principal residences, family farms for a price not over $1 million and transactions not involving more than $250,000 -- strike an appropriate balance between the interest of ensuring the proper tax treatment of deferred payment transactions and the competing interest of simplifying the tax treatment of transactions where unsophisticated taxpayers are likely to be involved and would not generally have the assistance of informed professional advisors. Therefore, we would not favor any enlargement of the exceptions to the original issue discount rules of section 1274.

Second, providing a below-market imputed interest test rate for certain transactions allows parties the flexibility to characterize deferred payments for Federal tax purposes in a way that is inconsistent with the true economic substance of the transaction. The resultant understatement of the buyer's and the seller's liability for tax constitutes a tax subsidy for these transactions. We are aware of no policy justification for providing a tax subsidy for sales of property, such as vacation homes, farmland or real estate associated with small businesses where financing is provided by the seller, rather than a third-party creditor. We do not propose that the Congress alter the final changes made to the imputed interest test rates under section 483. However, we would oppose the creation of further exceptions to allow the use of below-market interest rates in additional categories of transactions.

OPENING STATEMENT

SENATOR DAVID H. PRYOR
SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
AUGUST 3, 1984

HEARING ON THE TAX RULES DEALING WITH ORIGINAL ISSUE DISCOUNT AND IMPUTED INTEREST RATES.

Mr. Chairman, I'm pleased you've called this hearing today to examine the provisions of the Internal Revenue Code, as amended by the Deficit Reduction Act of 1984, dealing with imputed interest and original issue discount.

Several significant changes were made to these code provisions in Section 41 of the Deficit Reduction Act of 1984 in the area of seller-financed real estate. Although the more onerous parts of the section were corrected --- those dealing with sales of principal residences and small farms --- there are still major tax policy issues that must be resolved in this area. Our failure to do so before January 1, 1985 (the effective date of these changes) will create an unreasonable situation that will wreak havoc on many segments of the real estate market. There are several proposals that have been made since the passage of the Deficit Reduction Act, Mr. Chairman, and I hope the witnesses will present their views in regard to the provisions of prior law, how the new rules will operate, and what other alternatives are available to correct some of the problems that we know exist with the provision that was included in the bill.

Statement of Senator Pryor
August 3, 1984

Mr. Chairman, prior to the Deficit Reduction Act, the original issue discount rules only applied to a very few transactions. When the rules did apply, they were used to require current inclusion of ordinary income of the "original issue discount." It essentially put people on the accrual basis of accounting, in taking interest into account (and the original issue discount) for tax purposes. As such, it was designed to take away deferral possibilities and also to prevent the conversion of ordinary income into capital gain.

The imputed interest rules of the tax code, contained in Section 483, applied to more types of transactions. Under Section 483, as long as the debt instrument stated interest of nine percent (9%), you were out from under the rules. If, however, this wasn't the case (where no interest was stated, or a rate less than 9% was used) then interest was imputed at the rate of 10% compounded semiannually. These imputed rates were set by IRS regulation, not by statute.

Out of a concern over deferral of income; increased conversion of ordinary income into capital gains; and having an inflated basis in certain real estate transactions (thereby giving rise to larger deductions under the Accelerated Cost Recovery System) changes were made in the area of the OID rules and imputed interest provisions. With an expansion of the OID rules, the Section 483 rules were narrowed. The

major problem, however, under both provisions the rates are set at 110% of the applicable federal borrowing rate for the "safe harbor" rate, and at 120% of the applicable federal rate for the imputed rate. Thus, under either the OID rules, or the new imputed interest rules, if you don't have at least 110% of the applicable federal rate set out, then, for tax purposes, you're treated as having received 120% of the federal rate. The effect, Mr. Chairman, is to make more of the actual purchase price interest instead of capital gain or recovery of basis. This strikes me as wrong in the vast majority of cases. Further, and just as distressing, it ignores the economic realities. In a period of rising interest rates, this might be the only way property can be bought and sold, and if a rate is set this way in an arm's length transaction, the tax law should not step in and impute a higher rate.

If there have been abuses, as has been alleged by officials of the Treasury Department, then I think most members of the committee will want to deal with them. However, to drag all types of transactions into this broad net, is wrong.

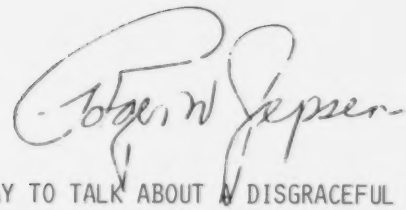
I hope this is a very productive hearing, and once again, I'm pleased that it is being held. After the hearing is completed, I hope we can take these recommendations and fashion a bill that gets at the problem without disrupting the normal day-to-day real estate transactions in this country.

STATEMENT OF

SENATOR ROGER W. JEPSEN (R-)IOWA

BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

AUGUST 5, 1984



MR. CHAIRMAN, I AM HERE TODAY TO TALK ABOUT A DISGRACEFUL LAW FORCED UPON THE PUBLIC BY CONGRESS AND IMPLEMENTED BY THE INTERNAL REVENUE SERVICE. I'M TALKING ABOUT IMPUTED INTEREST RATES AND THE DEVASTATING EFFECT THEY HAVE ON AMERICAN FAMILIES, FARMERS, AND SMALL BUSINESSMEN WHO WANT TO DO NOTHING MORE THAN SELL THE FAMILY HOME, FARM, OR BUSINESS TO AN ASPIRING YOUNGSTER FOR A DECENT PRICE.

RATHER THAN BEING ALLOWED TO PASS ON THE HOMESTEAD AT A MUTUALLY AGREEABLE INTEREST RATE, THE IRS TELLS US THAT WE HAVE TO PAY TAX ON AT LEAST A 9 PERCENT RATE. WHERE IS THE INCENTIVE TO KEEP THE PROPERTY IN THE FAMILY? HOW CAN WE EXPECT YOUNG PEOPLE TO GET STARTED IF NO ONE CAN AFFORD TO SELL THEM THE FARM OR BUSINESS?

MR. CHAIRMAN, I AM AWARE THAT IN 1963 THE TREASURY DEPARTMENT SAID THE IMPUTED RATE WAS NEEDED BECAUSE SOME PEOPLE WERE CONSTRUCTING DEALS THAT ALLOWED MOST OF THE PROFIT TO BE TAXED AT THE CAPITAL GAINS RATE RATHER THAN THE ORDINARY INCOME RATE.

PERHAPS THESE DEALS WERE BEING MADE. BUT THE EVIDENCE SUPPLIED BY THE TREASURY DEPARTMENT WAS PRETTY FLIMSY THEN AND IT REMAINS FLIMSY TODAY. IN THE COURSE OF GOING AFTER THOSE WHO SCHEME, THE IRS IS KNOCKING OUT THE AVERAGE HOMEOWNER, FARMER, AND BUSINESSMAN WHO WANTS TO HELP A BUYER WITH SELLER-FINANCING.

NOW SOME PEOPLE SAY THAT THE DEFICIT REDUCTION ACT WHICH WAS RECENTLY SIGNED INTO LAW PROVIDES EXEMPTIONS FOR THE SALE PRICES OF HOMES AND FARMS, SO THAT THE AVERAGE OWNER CAN CONTINUE TO USE THE 9 PERCENT RATE. BUT WHY IS THIS ANY KIND OF BONUS FOR THE AVERAGE OWNER?

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WE SHOULDN'T HAVE ANY IMPUTED RATE AT ALL. THE WHOLE IDEA SHOULD BE THROWN OUT THE WINDOW. ANYONE WHO TALKS ABOUT PRESERVING THE FAMILY AND GIVING YOUNG PEOPLE A CHANCE SHOULD BE OUTRAGED BY THIS INSIDIOUS ATTEMPT TO RAISE REVENUE.

THERE IS ANOTHER ANGLE TO THIS THAT I DON'T HEAR MANY PEOPLE TALKING ABOUT. THE IMPUTED INTEREST RATE ALSO AFFECTS AN OLDER PERSON'S ATTEMPT TO PREPARE FOR RETIREMENT. IF A PARENT, FOR INSTANCE, WANTS FO SELL THE FAMILY HOME AND ONLY HAS OFFERS THAT INVOLVE SELLER-FINANCING, HE MAY BE RELUCTANT OR UNABLE TO SELL THE HOME IF HE WILL HAVE A LARGE TAX BILL FOR DOING SO. AT THAT TIME OF LIFE, NO ONE NEEDS TO PAY MORE TAXES.

IN ADDITION, A FARMER SUFFERS DOUBLE ANGUISH BECAUSE OF THE IMPUTED INTEREST RATE. ON ONE HAND, IF HE WEREN'T SUBJECT TO THE RATE, HE WOULD HAVE A BETTER CHANCE OF KEEPING THE FARM IN THE FAMILY OR SELLING IT TO SOMEONE DEPENDABLE WHO WANTS A START IN LIFE. NOTHING TEARS UP A FARMER MORE THAN THE THOUGHT OF SELLING HIS FARM TO SOMEONE WHO WILL LET IT RUN DOWN.

ON THE OTHER HAND, A FARMER OR ANY PERSON READY TO RETIRE WANTS TO KNOW THAT THE MONEY HE HAS IS SUFFICIENT TO SUPPORT HIM FOR THE REST OF HIS LIFE. HE REALLY DOESN'T CARE IF HE HAS $1 MILLION OR $10,000, JUST SO HE CAN LIVE OUT HIS LIFE IN PEACE. WITH IMPUTED INTEREST RATES, HOWEVER, A FARMER MAY BE FORCED TO SELL OUTSIDE HIS FAMILY BECAUSE SOMEONE CAN OFFER A HIGHER PRICE AND NOT REQUIRE SELLER-FINANCING.

ALTHOUGH IT IS UNLIKELY THAT WE CAN DO AWAY WITH IMPUTED INTEREST THIS YEAR, I CERTAINLY SUPPORT SENATOR MELCHER'S BILL IN THE MEANTIME. THE DEFICIT REDUCTION ACT, WHICH I MENTIONED A MOMENT AGO, HAS FOR SOME INCOMPREHENSIBLE REASON SET THE IMPUTED INTEREST RATE AT 110 PERCENT OF THE T-BILL RATE FOR SALE PRICES OVER AN EXEMPT AMOUNT.

THE MELCHER BILL WILL ALLOW THE FIRST $250,000 OF A RESIDENTIAL PROPERTY SALE PRICE TO BE TAXED AT THE CURRENT RATE OF 9 PERCENT. IT ALSO ALLOWS THE FIRST $1.5 MILLION OF FARM SALE PRICE TO BE TAXED AT THE CURRENT RATE. I AM ESPECIALLY PLEASED THAT THE BILL CALLS FOR A $500,000 EXEMPTION FOR SMALL BUSINESS PROPERTY AS WELL. AT THE MOMENT, SMALL BUSINESSMEN ARE OUT IN THE COLD WITH NO PROVISION AT ALL FOR A LOWER RATE. ALLOWING THE FIRST HALF-MILLION TO BE TAXED AT 9 PERCENT IS A START, ALTHOUGH I WOULD PREFER TO SEE A HIGHER AND MORE REALISTIC AMOUNT SET FOR SMALL BUSINESSES.

MR. CHAIRMAN, I INTEND TO FOLLOW THROUGH WITH MY SINCERE BELIEF THAT WE SHOULD DO AWAY WITH IMPUTED INTEREST RATES. THIS WILL BE AN EXCELLENT TOPIC FOR DISCUSSION IN THE COMING MONTHS AS WE WORK ON TAX REFORM. EVERY HOMEOWNER, FARMER, AND SMALL BUSINESSMAN IN THE COUNTRY WILL THANK US IF WE BURY IMPUTED INTEREST RATES FOREVER.

NFIB National Federation of Independent Business

The Guardian of Small Business

STATEMENT

SUBMITTED BY

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

To: Senate Finance Committee

Subject: Imputed Interest Rules

Date: August 3, 1984

On behalf of the more than half million members of the National Federation of Independent Business (NFIB), we appreciate the opportunity to present the membership's views on a legislative proposal to clarify the application of the imputed interest rules in the case of a sale of a small business.

This issue surfaced as a result of passage of new rules on unstated interest and original issue discount in the recently enacted "Deficit Reduction Act of 1984." Prior law provided special rules for certain deferred and payment transactions which were not subject to the old OID rules.

If the parties to a deferred payment transaction did not specify a minimum rate of interest, a portion of the principal could be recharacterized as interest using an imputed rate of interest higher

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than the safe harbor rate. Section 483 of the Internal Revenue Code specifies the safe harbor rate as 9% and the imputed rate as 10%.

The expansion of the OID rules results in decreased availability of the old safe harbor rules under Section 483, unless a transaction is specifically excluded from the OID rules. Exceptions do exist for seller-financed sales of principal residences if the principal amount is not in excess of $250,000 and for owner-financed sales of farms where the principal is not in excess of $1 million.

The new OID rules become effective January 1, 1985, therefore timing is of the essence.

The concern over imputed interest rules is that they impact directly on small business much in the same way that initial capitalization problems affect small business. Small business has always faced a shortage of available capital for financing new and expanding small firms, and financing the sale of a small business presents similar obstacles. Long-term financing is generally unavailable to both new businesses and buyers of small businesses unless the buyer is in a position to offer a substantial amount of personal guarantees. Often the major asset of a small business is intangible, and a bank will find it difficult to lend the buyer sufficient funds to facilitate the purchase unless the buyer provides a personal guarantee.

To the seller of a small business who may wish to retire, the available market for his business is usually severely limited because of the inherent risks of buying a small business. Seller financing is often an integral part of the package necessary to facilitate a sale.

The seller often agrees to accept a below market rate of interest on deferred payments because paying market rates may be unrealistic for the buyer, who must both pay off the obligation to the seller and have enough left over to finance improvements in the business and possibly to finance expansion and growth. The seller recognizes this problem and is willing to accept the lower rate and the financial loss it presents to him.

Senators Melcher, Baucus, and Boren are to be congratulated for recognizing the severe impact that the imputed interest rules may have on sales of small businesses. We feel that the legislative proposal they have made solves the problem for those small firms under $500,000 in value.

If we existed in a financial world in which all factors were equal, application of the imputed interest rules in large and small cases would be fair. However, we are not living the dream of Adam Smith, and large firms do possess financial leverage small firms lack. Large firms can resort to various tax advantaged financing

methods, while small firms cannot. In fact it is of paramount importance for the seller of a small business that the buyer survive. If the buyer doesn't survive, the deferred payments stop, and a lifetime of effort plus his own financial security is wiped out.

NFIB supports the efforts of Senator Melcher and his cosponsors to allow for a small measure of equity in the imputed interest rules, and we thank you for the opportunity to make you aware of NFIB's position on this legislation.

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NATIONAL MULTI HOUSING COUNCIL

Suite 306 • 1150 Seventeenth Street, N.W. • Washington, D.C. 20036 • (202) 659-3381

STATEMENT OF STEPHEN D. DRIESLER
EXECUTIVE VICE PRESIDENT
THE NATIONAL MULTI HOUSING COUNCIL
BEFORE THE TAXATION SUBCOMMITTEE
OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE
AUGUST 3, 1984

Mr. Chairman, on behalf of the National Multi Housing Council, I am pleased to testify in support of legislation that would remove a very serious obstacle to the preservation and maintenance of affordable rental housing which was created by the recently enacted Deficit Reduction Act of 1984.

The National Multi Housing Council is a nationwide organization representing all aspects of the rental housing industry. Together NMHC members own or operate hundreds of thousands of rental housing units. We are deeply concerned with the impact which certain provisions of the 1984 Act will have on our ability to preserve and maintain these units at rents affordable to the low-to-middle income tenants who depend upon them.

Because of the substantial tax incentives that the Internal Revenue Code provides for home ownership, higher income tenants are constantly skimmed off the rental pool leaving only lower income tenants. For example, fourty eight percent of all renters have incomes below $10,000 per year whereas the average homeowner has an income in excess of

$20,000 annually. This is one of the main reasons why rental housing is generally perceived to be a risky form of real estate investment. Thus, prior to the enactment of additional tax incentives (primarily ACRS cost recovery) to encourage investment in real estate in 1981, there had been a steady decline in the production of unsubsidized rental housing and a deterioration of existing rental stock. The 1981 incentives combined with the lowering of interest rates and with the expanded availability of tax-exempt financing have created a long overdue recovery in rental housing.

The Deficit Reduction Act of 1984 ("the 1984 Act"), however, scales back the ACRS incentives for investment in real estate. In addition, the 1984 Act makes significant changes to the economics of those investments by both increasing the minimum required interest on indebtedness used to finance such investments and altering the timing of the recognition of interest income and deductions for federal tax purposes. These major reductions in real estate tax incentives embodied in the 1984 Act are already beginning to have a negative impact on the the rental housing market.

In particular, the 1984 Act's changes to the imputed interest and original issue discount provisions of the Internal Revenue Code (Sections 483 and 1274) have created significant disincentives for economically-necessary transfers and

rehabilitation of older rental housing. Rental housing is particularly affected because, in general, it is not a sufficiently secure investment to attract affordable third party financing. In addition, even if banks and other conventional lenders were willing to provide second mortgages or refinancing for most rental properties, the income from these properties could not support the additional financing without requiring severe rent increases. For most buildings such increases are not practicable, since they would exceed tenants' ability to pay. Federal restrictions and local rent controls also create barriers to the rent levels needed to support additional market rate financing.

Accordingly, existing owners often agree to take back a substantial amount of purchase money financing in order to raise new investment capital for a deteriorating project. The 1984 Act has made such purchase money financing much more costly because sellers must charge more than the comparable federal borrowing rate in order to avoid imputed interest and because they may not defer receipt of current installment payments without subjecting themselves to tax liability based on the "phantom" income which they have not yet received. As the cost of financing increases, rents will necessarily rise to levels which cease to be affordable to lower income tenants, thus forcing needed rental stock off the market either entirely or to more tax-favored condominum use.

In addition, the mandatory interest accruals required under the original issue discount rules of the new Code Section 1274 will prevent owners from rescuing troubled projects through the use of flexible and creative financing which nevertheless satifies the fundamental safeguards against overvaluation and income shifting already existing under the Internal Revenue Code. The flexibility under prior law to adjust financing to the specific needs of an apartment building often made possible the preservation of older rental stock. Accordingly, the National Multi Housing Council strongly supports the legislation (S.2815) introduced by Senator Symms and co-sponsored by Senators Dixon, McClure, Boren and Helms to repeal the new imputed interest provisions entirely. Further, the National Multi Housing Council believes rental housing, which is already at an inherent disadvantage in competing for private capital with other types of investments, should be exempted from the original issue discount provisions of the 1984 Act as well.

The Congress has properly recognized the need for continued flexibility in purchase money financing for personal residences costing up to $250,000 and for smaller farms, by exempting purchase money financing for these assets from both the new imputed interest and original issue discount rules. It should be noted, nevertheless, that rental housing, which for

tax purposes is already at a significant disadvantage compared to home ownership, has that disadvantage further increased by homeowners' exemption from these provisions.

Legislation (S.2894) introduced by Senator Melcher and co-sponsored by Senators Levin, Baucus, Sasser, DeConcini, Jepsen, Hatfield, Eagleton, Burdick, Boren and Randolph would expand the categories of property exempt from the new imputed interest provision to include property used in the trade or business with a value of $500,000 or less. This is a step in the right direction but, because rental property is generally valued on a per unit basis, the $500,000 cap would effectively discriminate against even mid-sized projects on the basis of size alone. Thus, as an alternative, if the complete exemption of rental housing is not now possible, we urge you to include among the exemptions from the new imputed interest and original issue discount rules rental housing costing no more than $50,000 per unit. A cap of $50,000 per rental unit is a reasonable figure which would not even approach a comparable level of luxury of a home costing $250,000. Such a limited exclusion is not only fair but essential if Congress wants to maintain rental housing in a competitive position vis-a-vis owner-occupied housing and to provide tax benefits for tenants which approach those given to homeowners.

We urge that any exemption for rental housing include both the original issue discount and the imputed interest provisions of the 1984 Act (Code Sections 483 and 1274). Requiring the seller of rental housing to recognize current income under original issue discount rules at a time when the project cannot both support increased debt service and maintain existing rent levels will force sellers to abandon rather than transfer deteriorating rental stock or will force buyers to increase rent levels beyond those which are affordable to traditional tenant groups -- the middle and lower-income classes. Moreover, the national impact on rent levels which would be occasioned by these Code changes is extremely regressive in that this type of "tax" falls primarily on those Americans least able to afford it. Thus, sound tax and housing policy both demand relief for rental housing from the new imputed interest and original issue discount rules.

Senator PACKWOOD. Gentlemen, your statements in full will be in the record as written. We would appreciate it if you would adhere to the time limit we have. As you can tell, I think there are going to be a fair number of interested questioners.

Why don't we start with you, Mr. Treadwell.

STATEMENT BY DONALD H. TREADWELL, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, DC

Mr. TREADWELL. Thank you.

My statement has been submitted. I would like just to summarize and make a few additional supplementary points.

My name is Donald Treadwell. I am president of the National Association of Realtors, a trade association with over 625,000 individual members who are involved in all aspects of the real estate business.

We would start off by saying that we certainly support those provisions which are aimed at closing the loopholes and preventing the abuses, particularly those in the area of the OID rules that address the question of interest accrual and, as the Secretary mentioned earlier, the mismatching of interest income and interest deductions; though we are not here to say that we should throw out everything and go back or turn the clock back.

We are concerned. I think the Members of Congress have indicated it, that there have been many legitimate nontax motivated transactions that are interfered with by the imputed interest rule. It has disrupted many of these situations. I think in these cases it increases the interest level which the buyers must charge sellers very dramatically and it does so by use of a very complex indexing formula, contained in changes in the imputed interest rules.

For that reason, we would like to address ourselves to that. We think the changes contained in the Tax Reform Act of 1984 are very bad for the economy and we think they are bad for individual transactions.

Specifically, we have included in my testimony some actual evidence which would indicate that the impact on the economy would be in the area of an approximate reduction of about $6 billion in total gross national product due to the inhibition of these transactions. The details are set forth there, and I would not go into that at this time unless there are some questions.

Flowing through that, of course, is a total of about 120,000 jobs, which based on the size of the economy may not be great but which is a very significant amount to those 120,000 people.

To answer in part the questions raised by the Secretary, we also think there would be about a $2 billion increase in Federal, State, and local taxes, due to this increased activity. As we are looking at this, this is not a static economy but a growing economy, and these provisions do have an effect upon the transactions which have been made.

We hope that there will be a consensus coming out of these hearings to address some of these more serious problems.

Senator CHAFEE. Mr. Treadwell, I wonder if you could give us an example of what you are talking about. I don't mean the loss of

jobs or the deferral of real estate activity, but just tell me of a little example of how this law would inhibit transactions.

Mr. TREADWELL. All right. In 1982 we had approximately 2 million existing-home sales. Of those, 34 percent or about 800,000 were seller-financed due to the fact that conventional lending was not available, the high interest rates, and all of the problems with it you are familiar with.

At the same time, about 41 percent of all the farm sales involved seller financing. Under these imputed interest rules, a very significant number of these would not have occurred, because the interest rates were more than the people could actually pay. And the result is, there would have been a reduction in the amount of total business activity, both in housing, farms, and certainly of course in some of your small businesses.

Senator CHAFEE. But under this act, it doesn't make them pay the interest; it just imputes the interest.

Mr. TREADWELL. That is correct.

Senator CHAFEE. The act affects the way the payments are demominated for tax purposes, but it doesn't affect the payments between the parties.

Mr. TREADWELL. I think this is an example of what I think is a fatal flaw of this whole argument. The arguments that the Secretary made and the argument that you have addressed is very fine if you are looking at this from an economic point of view, assuming that the average individual will go out there when they are making these transactions and be looking at cashflows and will be analyzing these very carefully. That——

Senator CHAFEE. But this act only applies to $250,000 houses and million dollar farms. This isn't just the fellow who walked in off the street, is it? There is some sophistication involved when you are selling a house for more than $250,000.

Mr. TREADWELL. Well, in my experience there is a very limited amount of sophistication at this level. When you get into the syndications and—not all of them, but the more expensive properties—certainly they retain tax counsel to analyze all of these things. But that isn't the way the transactions are done.

Let me just cite one specific example, in my own case. We had an industrial building. The property was sold for $650,000. It was about a 26,000 square foot warehouse. That is not a big commercial building. We sold it on a land contract. The interest rate was set at a relatively modest rate—at that time it was 10 percent, and this was about 2½ years ago. Why was it set that low? Because the alternative investments available were such that we couldn't get more than 10 percent. The buyer refused to pay any more than that because they had good sound credit and could borrow money on a short-term basis, which they were willing to do, and roll it over, of course.

The point is, this was a transaction structured strictly because of the exigencies of the market. It had nothing to do with the tax aspects of it; it was the fact that we wanted to retain an income flow, maximizing whatever we could. And this is the way most of these transactions are handled.

I would put the dividing line not at $250,000 or even at $1 million, but probably in the range of several millions of dollars before

you get to the point where you really start emphasizing all the tax aspects.

Senator CHAFEE. Thank you.

Senator PACKWOOD. Go ahead.

Mr. TREADWELL. I think in that same area we are looking at the aspect of the vacation homes. When they talk about them, we are thinking, of course, of the Gold Coast and the ski resorts and some of these places; but in Michigan we have literally thousands of 10-acre or 20-acre tracts up in the woods, land which is very low value, improved with small properties—very modest homes, usually without running water or if they have water it's a well and septic tank arrangement. These are absolutely not available for bank financing or any institutional financing. This is a second home, and this has to be covered by seller financing because that is the only way these properties can be sold. The imputed interest rules do not help us this way at all.

So I think that basically we are looking at a situation where, No. 1, the bill is structured as though it were being done by economists. That is not the way that even small businessmen operate in your commercial and industrial properties, up into the several millions.

But there are two other points I would like to make, if I might. Specifically, another reason why many of these transactions are not conducted at higher rates is because the sellers are not allowed under State usury laws to charge higher rates. We have made a preliminary sample, and the details are set forth in my testimony. In this area we have identified 11 States where the interest rate right now runs between 11 and 16.76 percent. Of these, six of them right now in some transactions, the usury rate is below the rate which would be required to be charged by Treasury. So we have the clash, where there is a maximum rate that can be charged by usury laws, and there is a minimum rate demanded by the Treasury. And the sellers are on the spot right in the middle. This issue was never even considered, I believe, in the testimony before the Senate and the House.

So, for these reasons I think it is poorly advised. The other point I would like to make in response to something that Treasury said: You mentioned the $250,000, the total payment transaction, in the OID rules. It is our understanding after examination of the law that this is fatally flawed because it does not flow through to the imputed rule section, and therefore it really does not answer the problem whatsoever. It is another example of the rush at the last minute, where adequate consideration was not given to the implications of this particular bill.

Just in summary, I would like to point out what our position is on the whole bill. The first thing, our preference is to repeal all of the changes to the imputed interest rules and go back to the old rules, which are simplified and understandable, and leave it up to Treasury to make the adjustments as reasonably necessary. If that can't be done, certainly we would suggest that you go to a sliding rate of about 80 percent and with a penalty of 110. Leave the penalty in, but the 80 percent under present law would be approximately 11 percent, which is about what the rates are running on this kind of mortgage.

The second thing, we would like to eliminate all consideration of farms from the new rules. We think the million dollar exemption is fine on most farms, but there are a lot of good examples where that is inadequate and should be removed.

With those changes, we would feel at least we would have a bill that would be workable and would reflect market conditions, instead of theoretical calculations made by economists.

Senator PACKWOOD. Mr. Koelemij?

[Mr. Treadwell's prepared statement follows:]

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
before the
SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
by
DONALD H. TREADWELL
August 3, 1984

I am Donald H. Treadwell and I am the President of the NATIONAL ASSOCIATION OF REALTORS®. The NATIONAL ASSOCIATION OF REALTORS® represents over 625,000 individuals engaged in all facets of the real estate industry. We commend the Chairman for holding these important hearings and for the opportunity to present our views regarding the most unnecessarily sweeping changes yet envisioned to the tax rules regarding the private, seller-financed sale of real property.

Mr. Chairman, the NATIONAL ASSOCIATION OF REALTORS® supports the intent of The Tax Reform Act of 1984 to eliminate tax abuse. We believe that the tax bill's extension of the Original Issue Discount (O.I.D.) concept to seller-financed real estate transactions will successfully stop the potential for abuse involving interest accruals--thus ending what is commonly referred to as the "mismatching of interest income and interest deductions." We do not now oppose this simple application of O.I.D. to real property transfers.

However, we are very concerned, as are members of this Committee and many members of both the House and Senate, that in the quest to eliminate tax abuse, many legitimate, economically motivated seller-financed real estate transactions including home, multifamily, farm and business sales will, at the very least, be substantially disrupted and in many cases stopped entirely. This will occur because in addition to extending O.I.D. to real estate, The Tax Reform Act dramatically increases the interest level which sellers must charge buyers and does so by use of a complex indexing formula which is unnecessarily burdensome for the average property seller.

Our data, which is summarized in an appendix to this testimony shows that about $30 billion of rental residential, commercial and industrial sales would be in jeopardy annually by The Tax Reform Act imputed interest provisions. This loss of sales would reduce the annual Gross National Product by up to $6 billion which represents about 120,000 fewer full time jobs and about $2 billion of lost federal, state and local tax revenues.

We anticipate that out of these hearings a consensus will develop to expand the improvements which Congress already has made in the Technical Corrections bill and sharply curtail the negative impact which these new imputed interest rules will have on buyers, sellers, consumers and the overall U.S. economy.

SUMMARY

For many years, the ability and willingness of owners to finance sales of residences, farms, multifamily dwellings and businesses at affordable interest rates has enabled people to continue to do business in spite of unaffordable rates charged by third party institutional lenders. This is especially true during high or rising interest rate periods. For example, during the high interest rate recession of 1982, 34 percent, or approximately 800,000 home sales involved seller financing and 41 percent of all farm sales involved seller financing at an average 11.8 percent interest rate.

Prior to the enactment of The Tax Reform Act, the law (Internal Revenue Code Section 483) had required sellers of real property who financed the transactions themselves to charge interest at a rate of nine percent simple, or be taxed as if they were receiving 10 percent compound. These safe harbor and imputed interest rate levels were fixed and subject to change by Treasury Department Regulation.

The Tax Reform Act now mandates, effective January 1, 1985, that sellers financing the sale of real property charge interest at least equal to 110

percent of the interest rate on Federal securities of comparable maturity. If interest is not charged at this level, then the Internal Revenue Service will impute interest to the transaction and tax the seller as if interest equal to 120 percent of the Federal rate were received. The average interest rate on long term Federal securities today is 13.7 percent; therefore, sellers are being asked to charge at least 15.06 percent interest or be taxed as if receiving 16.5 percent interest. These are unconscionable interest rate levels and clearly counterproductive to any effort to bring down interest rates and ensure continued economic recovery.

Supporters of these new, higher safe harbor and imputed interest rate levels make a seriously erroneous assumption to justify The Tax Reform Act provisions. These few assume that all sellers who provide financing at rates below those offered by third party institutional lenders do so solely because of taxation concerns. This simply is not the case.

For example, consider the preliminary analysis of random state usury laws below:

STATE INTEREST RATE CEILINGS FOR INDIVIDUAL LAND SALES CONTRACTS

STATE	USURY STANDARD	INDEX AT 7/12/84	MAX. RATE
Arkansas	5% above Federal Reserve discount rate	9%	14%
Kansas	1 1/2 above FHLMC daily mortgage offering	14.49%	15.99%
Kentucky	4% above Federal Reserve discount rate	9%	13%
Michigan	11% (No limit on loans of $100,000 or more, secured by property other then a single family residence.)		11%
Minnesota	4 1/2% above Federal Reserve discount rate (No limit for corporate borrowers, or on any loans of $100,000 or more.)	9%	13.5%

STATE	USURY STANDARD	INDEX AT 7/12/84	MAX. RATE
Mississippi	5% above Federal Reserve discount rate	9%	14%
Missouri	3% over monthly index of 20 year U.S. bonds	13.76%	16.76%
New York	16% on loans under $250,000 (No limit on larger loan unless it is secured by a 1 or 2 family house.) Limit is 25% if borrower is a corporation.		16%
North Dakota	5 1/2% over 6 month Treasury bill rate.	10.52%	16.02%
Tennessee	4% above prime as published by Atlanta Federal Reserve	12.71%	16.71%
Washington	4% over average rate for 26 week Treasury bills	10.52%	14.52%

Source: NATIONAL ASSOCIATION OF REALTORS®

In at least six states, Arkansas, Kentucky, Michigan, Minnesota, Mississippi and Washington, the new level of interest rates mandated under The Tax Reform Act exceeds the legally allowable state interest rate for land contracts. Although the imputed interest rate does not increase the interest payable by the buyer and therefore does not technically violate the usury laws, the new rules would require a seller to pay taxes on interest he would not legally be allowed to charge. We believe this is a ridiculous position in which to place taxpayers.

Further, common business practicalities dictate financing terms agreeable to both buyer and seller. Small commercial and industrial business owners need the flexibility to negotiate favorable financing terms especially during unstable economic periods. Most of the small property owners we are familiar with are fighting for survival and not engaged in tax abuse. Telling a property seller who is facing foreclosure and needs the flexibility to

transfer property that he must hold out for a higher interest rate is like telling a drowning swimmer that he must swim to shore. It may be good policy but is useless advice.

A simple examination of the facts in 1982 will demonstrate the potential disaster which these new provisions invite. In 1982, the average long term Federal security rate was 14.3 percent and the average seller financed interest rate was 11.8 percent. Had the new rules been in effect in 1982, sellers would have been required to charge 15.8 percent interest (110 percent of long term Federal security rate) or interest would have been imputed and the seller would have been taxed at 17.2 percent (120 percent of the Federal rate). Buyers would have been completely unable to afford 15.8 percent interest payments. In effect, a much more severe market collapse would have occurred.

Congress, in a Technical Corrections bill, has already recognized the lack of tax abuse in the sale of principal residences under $250,000 and the sale of farms under $1 million and provided that the pre-tax bill rules will apply to these transactions. Although the Technical Corrections bill provided a blend of current law rules and the new imputed interest rules for principal residences costing over $250,000, a cliff effect would occur under the legislation for farms costing over $1 million. Congress, presumably in an attempt to ease the burden of these new rules on small commercial and industrial business owners, also provided an exemption from the O.I.D. rules for total payment transactions of under $250,000 (Unfortunately, this attempted exemption is fatally flawed not only because it does not flow through to the imputed rules of Section 483, but also because the $250,000 includes total interest and principal payments and is itself an insufficient figure to assist commercial and industrial business owners).

It is the position of the NATIONAL ASSOCIATION OF REALTORS® that non-abusive seller-financing does not stop at the modest arbitrary limits set in the technical corrections bill and the plight of all other real estate and business owners needs to be addressed.

Countless scenarios bring to mind unintended consequences and unfair results. For example, we do not believe that Congress intended to require the retired couple owning a small vacation home, or the owner of a duplex rental apartment or the owner of any business operation to charge interest of at least 15 percent when financing the property's sale. Nor do we believe that Congress intended that the sale of a townhouse by investors to a family must carry an interest rate substantially higher than the rate allowed if the same property were sold instead by the family to the investors.

There is no difference, from a potential abuse standpoint between seller-financed sales of principal residences costing under $250,000 (eligible for pre-tax bill imputed interest treatment) and sales of other residential property -- including second homes, vacation homes and investment residential properties. While some may argue that second homes are owned only by the wealthy, the opposite is in our experience the truth. In fact, non-principal residences generally involve smaller secluded homes which are much more difficult to finance through institutional lenders. We urge that the principal residence exemption from the new rules be extended to exempt all residential property.

Farm sales of under $1 million were also wisely exempted from the new imputed interest rules. However, the necessity of available seller-financing for farm transactions extends well beyond this limit. Seller-financed farm sales accounted for 41 percent of all sales in 1982 and 33 percent of all 1983 sales. Farm costs by state vary widely across the United States and

agricultural lending is historically unaffordable. Although the average farm sale is below $1 million and therefore exempt from the new imputed interest rules, many farms, particularly those located in western high production areas exceed $1 million value. These farms are the backbone of the U.S. agricultural industry and should not be arbitrarily subjected to the new imputed interest rules.

Not only would the level of interest mandated under The Tax Reform Act for seller-financed real estate transations defeat the ability of sellers to counteract high institutional interest rates but the rules also present the very real possibility that seller provided interest rates would exceed the rates offered by institutional third party lenders. Such a situation would have occurred in June 1984 and is demonstrated below:

Maturity (years)	Yield on Treasury Securities 1/	110 % of T-securities	120% of T-securities	Mortgage Interest Rates 1/
1	12.1	13.3	14.5	13.0
3	13.2	14.5	15.8	14.2
5	13.5	14.9	16.2	14.8
10 or more	13.6	15.0	16.3	14.8

1/ Average for June, 1984
Source: NATIONAL ASSOCIATION OF REALTORS®

Clearly, if the imputed interest provisions contained in The Tax Reform Act of 1984 (IRC Section 1274 and Section 483 as modified by the Technical Corrections resolution) remain unchanged and become effective as scheduled January 1, 1985, then sellers financing sales of farms costing more than $1 million, small businesses, multifamily and commercial properties and "non principal" residential property could no longer negotiate their own affordable credit terms and would be required to state an interest rate equal to 110 percent of the comparable Federal securities rate, or under current market conditions approximately 15 percent compound interest.

RECOMMENDATIONS

The NATIONAL ASSOCIATION OF REALTORS® is extremely concerned that the imputed interest provisions contained in The Tax Reform Act of 1984 (Section 41 of the Act changing the existing imputed interest rules of IRC Section 483 and creating new IRC Section 1274) were enacted without a thorough appreciation of their substantial negative impact.

The NATIONAL ASSOCIATION OF REALTORS® does not favor the entry of the Federal government into freely negotiated sales contracts. The Federal government setting interest rates goes against the grain of a free enterprise system. It is bad economic policy. Further, when the rates are set as high as this law would set them, it is even worse. Lower interest seller loans are not only the key to the completion of many transactions, they act as a balance against high interest rates and help bring those rates down.

We would prefer that Congress act before January 1, 1985 and repeal all of the recent changes to the imputed interest rules (in both Sections 1274 and 483)and return to a sensible, fixed safe harbor rate of at least 9 percent interest.

Aware that total relief may be limited this year, we would therefore recommend at least the following immediate changes to The Tax Reform Act imputed interest provisions:

- a reduction in the Section 1274 and Section 483 safe harbor and imputed interest rate levels to 80 percent and 110 percent of the applicable Federal rate;

  --This would lessen the punitive nature of The Tax Reform Act but retain a link to market index. Under current conditions, an 80 percent safe harbor requirement would ensure seller-financed interest rates of 11 percent, not 15 percent as under The Tax Reform Act, and would ensure that in today's market sellers would

not be forced to violate state usury laws.

- an exemption from the new rules and a return to the pre-tax bill imputed interest rules (i.e. nine percent safe harbor and 10 percent imputed) for all seller provided financing of under $1 million;

  -- This would simplify the application of the tax for relatively unsophisticated sellers and thus avoid unnecessarily penalizing sellers of small commercial and industrial property as well as provide secure relief for residential property sellers, renters and consumers.

- an exemption from the new rules and a return to the pre-tax bill imputed interest rules (i.e. nine percent safe harbor and 10 percent imputed) for all farm sales.

  -- There is no indication that farm sales of any size involve abusive interest accruals or interest/principal manipulation -- this proposal would extend the $1 million farm exemption in The Tax Reform Act to all farms.

Thank you for the opportunity to present the views of the NATIONAL ASSOCIATION OF REALTORS® on this subject and I would be happy to answer any questions you might have.

LOSS OF GNP,JOBS, AND TAX REVENUES BY STATE

STATES	GNP	FULL-TIME JOBS	TAX REVENUES
Alabama	$103,813,360	2,076	$34,604,453
Alaska	8,165,814	163	2,721,938
Arizona	37,031,819	741	12,343,940
Arkansas	72,143,134	1,443	24,047,711
California	591,980,354	11,840	197,326,785
Colorado	75,846,621	1,517	25,282,207
Connecticut	91,721,497	1,834	30,573,832
Delaware	15,828,835	317	5,276,278
District of Columbia	23,038,318	461	7,679,439
Florida	144,548,418	2,891	48,182,806
Georgia	163,015,625	3,260	54,338,542
Hawaii	7,014,251	140	2,338,084
Idaho	16,247,031	325	5,415,677
Illinois	283,619,548	5,672	94,539,849
Indiana	169,808,637	3,396	56,602,879
Iowa	52,368,351	1,047	17,456,117
Kansas	44,412,374	888	14,804,125
Kentucky	86,053,334	1,721	28,684,445
Louisiana	101,143,883	2,023	33,714,628
Maine	56,659,309	1,133	18,886,436
Maryland	76,778,201	1,536	25,592,734
Massachusetts	193,469,432	3,869	64,489,811
Michigan	221,564,206	4,431	73,854,735
Minnesota	102,092,428	2,042	34,030,809
Mississippi	71,582,813	1,432	23,860,938
Missouri	128,160,498	2,563	42,720,166
Montana	11,304,900	226	3,768,300
Nebraska	22,059,441	441	7,353,147
Nevada	6,971,410	139	2,323,803
New Hampshire	41,659,637	833	13,886,546
New Jersey	228,885,290	4,578	76,295,097
New Mexico	15,680,820	314	5,226,940
New York	426,266,917	8,525	142,088,972
North Carolina	268,483,236	5,370	89,494,412
North Dakota	7,209,447	144	2,403,149
Ohio	320,551,754	6,411	106,850,585
Oklahoma	62,952,939	1,259	20,984,313
Oregon	66,973,698	1,339	22,324,566
Pennsylvania	362,990,928	7,260	120,996,976
Rhode Island	48,729,823	975	16,243,274
South Carolina	110,064,415	2,201	36,688,138
South Dakota	6,271,247	125	2,090,416
Tennessee	162,630,821	3,253	54,210,274
Texas	429,512,815	8,590	143,170,938
Utah	23,416,877	468	7,805,626
Vermont	11,010,072	220	3,670,024
Virginia	143,008,473	2,860	47,669,491
Washington	89,232,786	1,785	29,744,262
West Virginia	41,373,259	827	13,791,086
Wisconsin	139,337,476	2,787	46,445,825
Wyoming	15,313,432	306	5,104,477
TOTAL	$6,000,000,000	120,000	$2,000,000,000

The NATIONAL ASSOCIATION OF REALTORS® is comprised of more than 1,806 local boards of REALTORS® located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is over 600,000 persons actively engaged in sales, brokerage, management, counselling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry.

Elected officers are: President Donald H. Treadwell, Southgate, Michigan; President-elect David D. Roberts, Mobile, Alabama; First Vice President Clark E. Wallace, Moraga, California; Treasurer Phillip C. Stark, Madison, Wisconsin.

The Chief Administrative Officer is Jack Carlson, Executive Vice President and Chief Economist.

The Senior Vice President, Government Affairs is Albert E. Abrahams and the Vice President and Legislative Counsel, Government Affairs is Gil Thurm.

Headquarters of the Association are at 430 North Michigan Avenue, Chicago, Illinois 60611. The Washington Office is located at 777 14th Street, N.W., Washington, D.C. 20005. Telephone (202) 383-1000.

STATEMENT OF JOHN KOELEMIJ, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Mr. KOELEMIJ. Senator, thank you.

My name is John Koelemij. I am a homebuilder from Tallahassee, FL, and I appear today on behalf of the more than 125,000 members of NAHB, of which I am first vice president.

Before I start, I would like to compliment Chairman Dole on his efforts to move and obtain passage of the complicated tax bill this year.

In testifying today, NAHB does not seek to unravel the recently enacted deficit reduction package. NAHB supported this effort even though it places significant additional taxes on the housing and real estate industry.

We believe we have paid our fair share in this deficit reduction effort. Unfortunately, the far-reaching implication of the imputed interest and OID rules in the bill were not recognized until the late stages of the process, even though we testified on this matter before the House Ways and Means Committee on February 28 to call these items to the attention of the Members of the House.

Homeowners and small businessmen are beginning to digest the full impact of the changes. NAHB therefore wants to outline briefly some of the potential adverse effects.

NAHB supports the efforts of Senators Symms, Melcher, and other members of the Senate Finance Committee, as well as Congressman Archer to reexamine or repeal these provisions. The current rules should not go into effect in their current form, if at all. There should be a thorough review. To go into effect on January 1, 1985, as proposed, would have a chilling effect on real estate transactions and serve to raise the cost of housing, both rental and ownership.

High interest rates have made seller financed installment sales of property a popular alternative to third-party commercial financing. Homeowners, owners of multifamily and commercial property, and homebuilders, have negotiated financing at interest rates significantly below market rates. The original issue discount and imputed interest rules would enforce negotiated rates to equal or exceed commercial rates, intruding upon the private marketplace and restricting property sales.

The following policy implications emerge: First, the change has built a high interest rate into most private deferred-payment transactions. Instead of imposing a Federal rate for sales below the 9-percent level as under the current law, it requires that rates be established above the Treasury's cost of money at the time of the transaction This means that negotiated private sales, to the extent tax considerations are factored into the decision, will always be at a higher rate than the Federal rate. The private marketplace will not longer be a vehicle for bringing rates down. Instead, the Federal Government will dictate what the market will charge.

We feel obligated to raise the question of why the Congress or the administration would seek to establish rules that artificially prop up interest rates. It is counterproductive to economic growth and stability.

Second, interest rates for seller-financed transactions will increase. In today's market, for example, a homebuilder would have to charge a rate which exceeds 14 percent in a seller-financed home sale to avoid the adverse consequences of the OID and imputed-interest provisions. Mr. Chairman, if that rate were applied to a $72,000 mortgage, about 3 million families would be priced out of the market, compared to a 12-percent rate.

Third, the changes will curtail investment in low-income housing. The housing stock for low-income renters will decline. Sale of low-income property is an important way if not the only way to upgrade that property. Prior to the OID changes, sales often involved deferred interest purchase money loans. The final payments of interest would not be made until the property was sold. This permitted the cash flow to support the debt service. The OID rules will require sellers to pay tax on income which they have not received.

We believe that requirement is unfair; the result will be a reduction in the attractiveness of housing as an investment. As a result, low-income properties will continue to decline, and HUD would eventually have to reacquire and operate these properties at considerable cost to the Government.

NAHB urges the committee to consider this very carefully. He also urge the committee to work with HUD to analyze the implications for the existing housing stock.

NAHB concludes that Congress should not allow these changes to go into effect prior to the appropriate changes being made. Congress should analyze these issues thoroughly and redesign the provisions; both the imputed interest provision and OID previsions must be dealt with simultaneously. Relief for one and not the other would not be fair or equitable.

The test for imputed rates is too high. A cap on the upward escalation of the imputed rates should be enacted. NAHB recommends somewhere between an 11- and 12-percent cap. Dollar exemptions should be provided as well for the sales of homes, land, multifamily and commercial structures, farm and small businesses.

Thank you for the opportunity, Mr. Chairman, to present our views, and I will be ready to answer any questions.

Senator Packwood. Thank you. That is a good statement.

Mr. Deines.

Senator Dole. That's a Kansas name. Do you have any relatives in Kansas?

Mr. Deines. A lot of them, Senator.

Senator Grassley. That's why they sent him. [Laughter.]

Senator Packwood. Go right ahead, sir.

[Mr. Koelemij's written testimony follows:]

STATEMENT OF

NATIONAL ASSOCIATION OF HOME BUILDERS

BEFORE THE

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT

ON

ORIGINAL ISSUE DISCOUNT AND IMPUTED INTEREST RULES

August 3, 1984

Washington, D.C.

Mr. Chairman and Members of the Subcommittee:

My name is John Koelemij and I am a homebuilder from Tallahassee, Florida. I appear here today on behalf of the more than 125,000 members of the National Association of Home Builders (NAHB), of which I am First Vice President. NAHB is pleased to present its views on original issue discount and imputed interest rules. NAHB supported deficit reduction legislation, even though it significantly increased taxes upon the real estate industry. A major concern,however, was the original issue discount provisions and the related imputed interest changes. Our primary focus was upon the effect of these changes upon multifamily housing, particularly resyndications of low income projects. In the late stages of the legislative process, further implications of the imputed interest changes (Section 483 of the Internal Revenue Code) began to surface.

To understand the problems, it is important to recognize that seller financed installment sales of property have become an increasingly popular alternative to commercial financing. Parties

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dealing at arm's-length in such transactions are often willing to negotiate interest rates less than those charged by commercial lenders in order to consummate sales. Without the ability to negotiate such lower rates, many sales of property would never take place. The Tax Reform Act of 1984 ("TRA 1984") modified the original issue discount (OID) rules and § 483 imputed interest rules to force parties dealing at arms-length to negotiate rates equal to or higher than commercial rates, or else face adverse tax consequences. These new deferred payment provisions will severely restrict the ability of many property owners to sell their property under the current high interest rate environment.

NAHB, therefore, supports the efforts of Senators Symms and Melcher and Congressman Archer and others. Congress should reexamine the whole issue of the relationship between principal and interest in a deferred payment context and develop workable rules.

At a minimum, the current rules should be substantially revised. A cap of twelve percent should be placed as an upper ceiling for OID and imputed interest rates. The test rate should be set at 80 percent of the applicable federal rate and the imputed rate should be set at 100 percent of the applicable federal rate. Dollar exemptions should be provided for transactions involving the sales of homes, raw land, multifamily and commercial structures, family farms, and small businesses.

The following testimony will discuss the recent changes, the impact of the changes upon the housing industry, and NAHB's recommended changes.

I. RECENTLY ENACTED ORIGINAL ISSUE DISCOUNT AND IMPUTED INTEREST RULES

New and Modified OID Rules

Section 41(a) of 1984 Tax Act expands and modifies the TEFRA OID rules. Most significantly, it extends these rules to debt instruments issued for property, whether or not the debt instrument or the property is actively traded on an exchange. The rules will thus apply to any debt instrument (bond, debenture, note, or any other evidence of indebtedness) issued in exchange for real estate, machinery or other property.

Where a debt instrument is issued for nontraded property, the stated principal amount of the obligation is tested by discounting all payments to be made at a rate of 110 percent of the "applicable federal rate" (AFR). The AFR is to be determined periodically by the Secretary on the basis of current rates of short-term (not more than 3 years), medium-term (not more than 9 years) and long-term (over 9 years) U.S. Government obligations. If the stated principal amount is greater than the test amount, an "imputed principal amount" is computed by discounting all payments to be made at a rate of 120 percent of the AFR. The result leads to a computation of OID which must be amortized over the life of the instrument by both issuer and holder, whether cash or accrual basis.

A number of transactions are exempted from the revised OID rules: debt instruments arising from the sale of a farm by an individual or a small business (with a $1 million limitation); sales of personal residences; sales of any property where the total payments to be made do not exceed $250,000; sales of patents (where the amount is contingent on the productivity, use or

disposition of the patent); and sales of land between family members to which §483(f) (unchanged from prior law) applies. These exemptions do not apply to instruments issued for actively traded stock or securities or to instruments which are themselves actively traded.

The original issue discount rules seek to recharacterize the principal and interest elements of a deferred payment transaction to take into account the present value of the payments based upon a discount rate which is driven by the government's cost of money. The rules apply concepts to private transactions which are similar to publicly traded securities such as zero coupon bonds. They impose a system of tax accounting for interest and principal payments which may be different from the stated interest and principal payments which the parties negotiate in the transaction. Payments of principal are recharacterized as interest, and therefore income to a seller or lender, where the stated interest rate falls below the statutory rate. The debtor-purchaser will receive a corresponding deduction. Principal is recharacterized as interest payments, thereby reducing the principal element, for tax purposes, and increasing the interest element.

Amendments to §483 (Imputed Interest)

The other side of the OID rules are the changes in the imputed interest rules.

Section 41(b) of TRA 1984 enacts a completely revised §483 which adopts rules similar to the OID principles discussed above. As under prior law, §483 applies only to payments made under an installment contract for the sale or exchange of property. It operates, where there is "unstated interest", to recharacterize as

interest that portion of the purported sales price which is deemed attributable to a charge for the use of money.

Under new §483, the total of all payments of the sales price provided in the contract is compared to the present value, applying a discount rate of 110 percent of the applicable federal rate (explained above), of all payments to be made under the contract, including payments of interest. If the former exceeds the latter, there is unstated interest. The sales price is then determined by discounting all payments due, using 120 percent of the AFR. The resulting revised interest amount is accruable using a constant rate or compounding basis as in the case of an OID instrument. However, unlike the OID rules, a cash basis seller need not include any interest in income until the year of receipt of payment.

As under former law, the revised §483 does not apply to any payment due within 6 months from the date of sale or to any contract unless some or all payments are due more than one year from the date of sale. Also, a debt instrument issued by the buyer is not considered a payment.

Therefore, §483 does not apply to any debt instrument to which the OID rules apply.

In addition, neither the OID rules nor §483 apply to:

- sales where the sales price cannot exceed $3,000,
- sales of patents and
- sales by an individual of his personal residence (to the extent the sales price does not exceed $250,000) and any sale or exchange by a person of land used by such person as a farm. [In such cases, the unstated interest rules of

prior law (9 percent simple interest test rate and 10 percent compounded semi-annually to determine unstated interest) will continue to apply.]

The important point to remember is that the old imputed rules only affected rates below nine percent. The changes will drive negotiated interest rated above the federal government's cost of money.

II. IMPLICATIONS

First, the changes build high interest rates into most private deferred payment transactions. Instead of imposing a federal rate for rates below a certain level, it requires that rates be established above the Treasury's cost of money at the time of the transaction. This ensures that negotiated private sales, to the extent tax considerations are factored into the decision, will always be at a rate higher than the federal rate. Because the rate must be the rate at the time the transaction is negotiated, this rate will vary. In a high interest environment, private negotiated sales no longer will be a mechanism to bring down interest rates.

Interest rates, privately negotiated, will follow the federal government's cost of funds.

This is a major shift in philosophy. During the high interest rates of 1981 and 1982, private seller financed sales in the real estate industry were a major way to continue real estate activity even though public rates were at an 18 to 20 percent level. New home sales, sales of used homes, and sales of commercial and multifamily projects survived because sellers and buyers were willing to negotiate based upon interest assumptions which were well below the

market. This benefited the economy by keeping some new construction alive and by unlocking capital and providing new capital into the system.

Second, under current conditions, interest rates for seller financed transactions will increase. Homebuilder-financed sales of individual homes involving total payments of principal and interest below $250,000 fall under the §483 imputed interest provisions. In order to avoid the amortization of OID by both buyer and seller or the imputing of interest, a homebuilder must charge a rate of interest on an installment obligation issued by the buyer equal to or greater than 110 percent of the AFR. Since most home mortgages exceed 15 years, the AFR applicable to homebuilder-financed sales of homes generally will be the "Federal long-term rate", conservatively estimated to be 13.5 percent (given the current average market yield on U.S. obligations with remaining periods to maturity of over 9 years). 110 percent of 13.5 percent is 14.85 percent; thus, a homebuilder would have to charge a rate of 14.85 percent in a seller-financed home sale to avoid the adverse consequences of the OID and imputed interest provisions. This is a very high rate which kills virtually all new home sales.

Although the underlying purpose of homebuilder-financed sales of homes when commercial interest rates reach that level is to produce a negotiated interest rate substantially lower than such rates, the new OID and §483 imputed interest rules impose an even higher rate on homebuilder financed home sales. That result undermines the whole concept of contractual terms and obligations freely negotiated at arm's-length.

Third, the new system will increase interest costs which will ultimately be passed on to consumers. This will show up in many different ways. Obviously, multifamily projects will require a higher rate of interest when deferred payment transactions are made. The result will be to increase the debt service burden for the project, thereby requiring higher rents to make the project feasible.

For purchasers of new homes, the cost of new homes will increase. This is because land sales often involve privately negotiated seller financing. The deferred payment provisions will also add significantly to the homebuilder's costs of development and the construction of new homes. A builder typically will purchase raw land for the purposes of development and the construction of housing tracts in an owner-financed installment transaction. This financing is generally set at the lower §483 rates, in the neighborhood of ten to twelve percent.

The new OID and §483 imputed interest rules -- whether one or the other applies -- will require a commercially equivalent rate. That added interest cost must be made up by the homebuilder in the price at which he sells newly constructed homes. Accordingly, the new deferred payment rules may well drive up the price of new homes. The interest cost of carrying land during construction will increase. The end result is that builders, to maintain current profit margins, will have to raise the cost fo the final product to the consumer.

Fourth, the changes will eliminate investment in low income housing. The housing stock for low income renters will be forced to gradually decline. This is because many HUD projects which are

low income projects have inadequate reserves for repairs and maintenance. One of the major benefits from the 1981 tax law was to infuse capital into low income projects and bring new investors. These investors were seeking tax benefits associated with real estate investment and were willing to place new capital into projects which were badly in need of refurbishing. The HUD guidelines required additional repairs, maintenance and higher levels of reserves. Because the income from these projects was inadequate to suport the debt service, the transactions often involved negotiated arrangements between buyers and sellers for low interest purchase money loans in which final payments of interest would not be made until sometime in the future. This permitted the cash flow to support the debt service.

The OID rules, which will reduce the principal for purposes of depreciation write-offs and require sellers to recognize phantom income, will cause these type of transactions to no longer be attractive from an investment point of view. The result is that many HUD properties will continue to decline and HUD may often have a high inventory which will be very costly to maintain and operate.

NAHB urges the Committee to consider this very carefully as part of the OID changes. We also urges the Committee to investigate with HUD the implications of these changes for the housing stock.

Finally, the new rules are technically inconsistent and have created a great deal of market confusion. The technical inconsistencies relate to the complete exemption from OID for personal residences as compared to the $250,000 cap under the imputed interest rules. A similar situation exists with regard to the $1 million

exemption for family farms under OID.

Other technical problems emerge. What, for example, do you do with wrap-around transactions? What about loan assumptions? What about situations in which the interest payment is contingent upon various cash flow payments? What is the formula for computing original issue discount? All of these questions create confusion in the marketplace. This confusion aggravates an already unstable market environment because of concern about interest rates and the federal deficit.

III. NAHB POSITION AND CONCLUSION

The changes with regard to original issue discount and imputed interest create major problems from both a technical and policy viewpoint. The provisions build high interest rates into privately negotiated transactions. NAHB concludes that Congress should reconsider the entire issue. NAHB supports the efforts of Congressman Archer and Senators Symms and Melcher to achieve this result.

At a minimum, a more realistically designed provision needs to be enacted. The test for imputed rates is too high. A cap on the upward escalation of the imputed rate should be enacted. NAHB recommends a 12 percent cap. Dollar exemptions should be considered for homes, raw land, and commercial and multifamily structures.

Thank you for the opportunity to present our views. I would be happy to answer any questions you may have.

STATEMENT BY HARRY J. DEINES, MANAGING PARTNER, DEINES AGRICULTURE & LIVESTOCK CO., FORT COLLINS, CO, ACCOMPANIED BY HOVER T. LENTZ, ESQ., LENTZ, EVANS & KING, DENVER, CO

Mr. DEINES. I am Harry Deines, managing partner of the Deines Agriculture & Livestock Co. in Larimer County, CO. I appreciate being here, because it is clear that a lot of oxen are being gored. It's comforting to know that mine is not the only ox being gored by this Deficit Reduction Act.

On April 30 of this year the Deines Agriculture & Livestock Co., which is a family-farm ganeral partnership, signed a binding agreement to sell our farms, which have been owned and operated by the Deines family for over 60 years, to the Del E. Webb Corp., developer of Sun City, AZ, among other things.

The retroactive application of the new original-issue discount and imputed interest rules of the Deficit Reduction Act of 1984 converts a substantial portion of the appreciation on these farms from long-term capital gain to ordinary income.

We feel that the sale of nondepreciable farmland at fair value with seller-carryback financing does not have tax-avoidance aspects. To the extent that we get more interest income, Webb gets more interest deductions, it should not be treated in the same manner as the sale of depreciable property at an artificially inflated price to a tax-shelter promoter.

We believe that in general sales of farmland are not tax abusive and therefore should not be subject to the new rules imputing very high interest rates to seller financing. In particular, we urge that these rules should not be imposed retroactively to transactions contracted in good faith more than 2½ months before the Tax Act was signed.

If I may, let me give you a little historical background to support why we feel this way.

My parents, John and Mary Deines, farmed in Larimer County for more than 40 years—a dry-land farm. They had six children. John died in 1962, and Mary continued to operate the farms with the help of her children, and she died in 1969. The farms, 1440 acres with modest farm buildings, were included in her gross estate for Federal estate tax purposes.

The farms were inherited by Mary's children, who formed a general partnership. The land is still farmed, under my supervision, and it will be farmed for a good many more years, most of it, even if it is sold and developed.

The farms lie adjacent to U.S. Highway 287, now a six-lane highway, between Loveland and Fort Collins, CO, as shown on the attached map which I believe you have. This area of Colorado has enjoyed phenomenal growth in recent years, attracting companies such as National Cash Register, Eastman Kodak, Hewlett-Packard, Teledyne, Anheuser Busch, and many smaller concerns. Fort Collins is also the home of 20,000 students at Colorado State University. Four years ago, 800 acres of our land became eligible for annexation to the city of Fort Collins. We voluntarily petitioned, were annexed, and were given zoning for master-planning the land for urban uses.

The Deines partners, all in their 60's and 70's decided to sell the farms. So in 1980 all our land was listed for sale at prices ranging from $2,500 to $15,000 per acre, with the total aggregating at about $8 million.

From 1980 through 1982 land sales in our area were weak. A few purchase offers were made on terms unacceptable to us, but no one seriously questioned our price. Last winter we were approached by Del E. Webb Corp.—as you know, they are a publically-held corporation—and at that time Webb indicated that the price of $5 million for 536 acres nearest the Highway 287 was fair and acceptable. There were, however, long discussions concerning the terms and other conditions to closing the contract. Finally, a binding receipt and option contract was signed on April 30, 1984, providing for the purchase of the 536 acres.

In addition, the contract granted Webb an option to purchase the additional 245 acres of the land that is in the city.

Now, the terms were $1 million in cash down, with the balance of $4 million being payable in 20 equal semiannual payments of $200,000 each, together with interest on the unpaid balance at the rate of 5 percent the 1st year, 6 percent the 2d year, 7 percent the 3d, 8 percent the 4th, 9 percent the 5th, and 10 percent the 6th through the 10th year.

Senator PACKWOOD. Mr. Deines, I have to ask you to conclude, if you can.

Mr. DEINES. These extended terms at low interest rates were required by Webb to partially offset the necessary expenditure of very large amounts of front-end money to develop the property, before it could sell lots for single family and multiple housing and industrial and commercial buildings. During these negotiations, we were aware that interest would be imputed to our partners at 10 percent under the existing revenue code and the related regulations. However, we were shocked to learn that the provisions of H.R. 4170, as passed by the Congress and signed on July 18, 1984, by the president, retroactively imputes interest on our sale not at 10 percent as has been the law for many years prior to July 18 but at the rate of 120 percent of the rate at which the Federal Government borrows money on a 10-year bond. Today this rate would be between 15.5 and 16 percent, and this retroactive legislation will increase Federal income taxes to the Deines partners over the terms of the contract by about $175,000.

The closing can take place at any time prior to the end of March 1985.

Senator PACKWOOD. Mr. Deines, I will have to ask you to conclude. We try to hold the witnesses to 5 minutes, and I have let you go over; but you have to wrap your statement up.

Mr. DEINES. Right.

I believe there is no question that our price is fair, regardless of the terms of payment. Our terms are well in line with the seller-financing practices for sale of farmland to development, and we feel strongly that the appreciation of our property, which we have held for so long, should be taxed to us as long-term capital gains and not retroactively and arbitrarily converted in substantial part to ordinary income.

I think we have a hardship case justifying either (a) grandfathering our transaction from the retroactive application of the new law, or (b) exempting it from the new rules with all sales of farmland, regardless of the time of sale and the selling price.

I urge Congress to continue the old 483 rules in effect for the pending sale of our farmland and all other sales of farm and ranch land.

Thank you.

Senator PACKWOOD. Thank you very much, Mr. Deines.

[Mr. Deines' written testimony follows:]

STATEMENT OF HARRY J. DEINES
COMMITTEE ON FINANCE
TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE
AUGUST 3, 1984

Hearing Concerning Provisions in the
Tax Reform Act of 1984 Dealing With Imputed Interest
Under Internal Revenue Code Section 483 and
Original Issue Discount Under New Code Section 1274

SUMMARY OF PRINCIPAL POINTS

On April 30, 1984, Deines Agriculture and Livestock Company ("Deines") signed a binding agreement to sell Northern Colorado farms owned and operated by the Deines family for over 60 years to Del E. Webb Corporation ("Webb"), the developer of Sun City, Arizona. The retroactive application of the new original issue discount and imputed interest rules contained in §§41-44 of Deficit Reduction Act of 1984 ("Act") converts a substantial portion of the appreciation on these farms from long-term capital gain to ordinary income.

A sale of nondepreciable farm land at fair value with seller carryback financing does not have tax avoidance aspects; to the extent Deines gets more interest income, Webb gets more interest deductions. It should not be treated in the same manner as the sale of depreciable property at an artificially inflated price to a tax shelter promoter.

We believe that, in general, sales of farm land are not tax abusive and, therefore, should not be subject to the new rules imputing very high rates of interest to seller financing. In particular, we urge that these rules should not be imposed retroactively to transactions contracted in good faith more than 2-1/2 months before the Act was signed into law.

I am Harry J. Deines, Managing Partner of Deines Agriculture and Livestock Company ("Deines"), 1707 Country Club Road, Fort Collins, Colorado 80521. Deines has a serious problem with the above provisions of HR 4170 as applied to our facts and circumstances.

My parents, John and Mary Deines, operated partially irrigated and partially dry-land farms in Larimer County, Colorado, for over 40 years. They had six children. John Deines died in 1962. Thereafter, his widow Mary operated the farms with help from various children. She died in December 1969. At that time, all the farms (1,440 acres with modest farm buildings) were included in her gross estate for Federal estate tax purposes.

The farms were inherited by Mary's six children and since her death have been operated by a general partnership, Deines Agriculture and Livestock Company. Subsequently, one child sold his interest to my wife, and several other partners made gifts of a portion of their interests to their spouses. The land has been and still is farmed by tenant farmers under my supervision.

The farms lie immediately adjacent to U.S. Highway 287 between Loveland and Fort Collins, Colorado, as shown on the attached map. This area of Colorado has enjoyed phenomenal growth in recent years with companies such as NCR, Eastman Kodak, Hewlett-Packard and Teledyne locating large

manufacturing facilities in the area. Fort Collins is the location of 20,000-student Colorado State University, which has also attracted substantial growth to the area. Several years ago, a portion of the Deines property was annexed to Fort Collins.

The Deines children who are still partners are all in the 60s and 70s and a few years ago decided to sell the farms. All the farms were listed for sale in 1980 at a price for the various parcels aggregating about $8,000,000. Since then, farm and land prices in that vicinity have been weak and no sales were made, although a few approaches were made on payment terms unacceptable to Deines, although none seriously questioned the price.

Last winter, Deines was approached by Del E. Webb Corporation ("Webb") through its agent, Del E. Webb Realty and Management Company. Webb is a publically held corporation best known as the developer of Sun City, Arizona. At that time, Webb indicated that it felt the asking price of $5,000,000 for approximately 536 acres nearest to the highway was fair and acceptable. There were, however, extensive discussions concerning the conditions to closing the contract and the terms of payment. Finally, a binding receipt and option contract was signed on April 30, 1984 providing for the purchase of 536 acres in four parcels with prices of $15,000

per acre for the eastern parcel (Parcel 1 on the attached map) adjoining U.S. Highway 287, $8,617 per acre for parcels 3 and 4 immediately to the west and $8,000 per acre for parcel 2 further west which is bisected by the railroad. In addition, the contract granted Webb an option to purchase parcel 5 (245 acres) at $8,000 per acre and a 10-year right of first refusal to meet any third-party offer on 640 acres of dry farm land located along the foothills a mile or so west of the property being purchased.

The terms of payment are $1,000,000 in cash down with the balance of $4,000,000 being payable in 20 equal semi-annual payments of $200,000 each, together with interest on the unpaid balance at the rate of 5 percent per annum in the first year, 6 percent in the second year, 7 percent in the third year, 8 percent in the fourth year, 9 percent in the fifth year and 10 percent in the sixth and subsequent years.

These extended terms at low interest rates were demanded by Webb to permit it to expend very substantial amounts of time and money on the front end of the development of the property before it can make sales for single family housing, multiple housing and industrial and commercial purposes. During these negotiations, Deines was aware that interest would be imputed to its partners at 10 percent per annum under §483 of the Internal Revenue Code and the

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related regulations. However, we were shocked to find that the provisions of HR 4170, as passed by Congress and signed on July 18, 1984 by the President, retroactively imputes interest to Deines on our sale not at 10 percent, as has been the law for many years prior to July 18, but at a rate of 120 percent of the rate at which the Federal Government borrows money on a 10-year bond. Today this rate would be between 15-1/2 and 16 percent. We estimate that this retrospective legislation will increase Federal income taxes to the Deines partners by about $175,000.

The closing can take place at any time prior to the end of March 1985 at Webb's option, and probably will take place in 1985. The statute bears an effective date of March 1, 1984 for contracts such as ours that are closed after 1984. There are good business reasons for closing after 1984 since Webb needs many months to complete all of their preliminary studies and planning and obtain needed governmental approvals before closing the purchase.

Congress, in adopting the new and more stringent imputed interest and original issue discount provisions, was concerned primarily with tax shelters where these provisions were being abused in order to create very high current deductions for a promoter's investors. This is obviously not the case in this instance since depreciable improvements on our farms are negligible. While we will have more interest income, Webb will have more interest deductions. Clearly,

the sale of our farms which have been in our family for over 60 years and have now become very valuable as urban real estate is not the same as the disposition of depreciable property to a tax shelter syndicator at an inflated value.

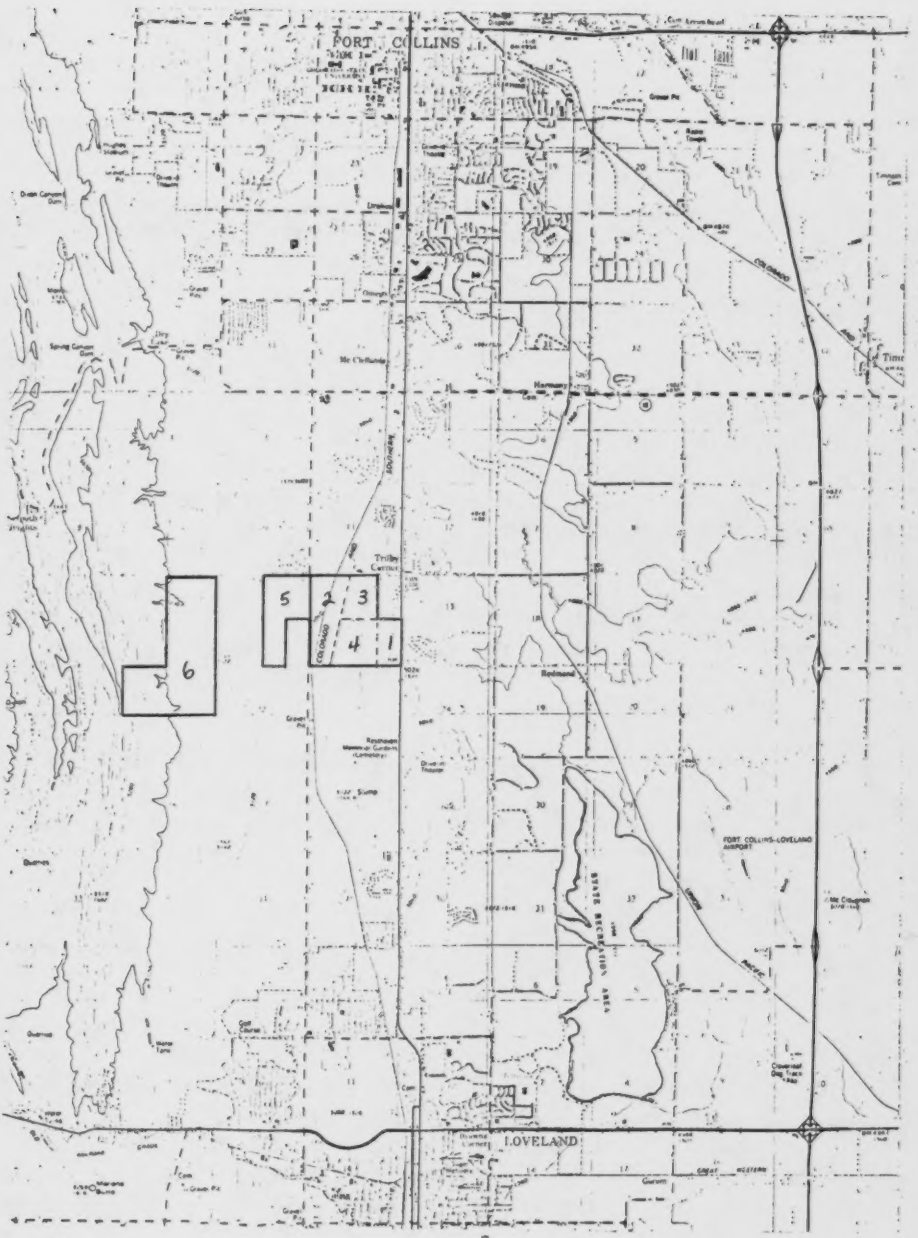
While we do not have an appraisal of our property as of a recent date, we believe that there is no question that the price is a fair one, regardless of the terms of payment. Our terms are well in line with the seller financing practices for the sale of farm land for development.

We feel strongly that the appreciation of our property, which we have held for so long, should be taxed to us as long-term capital gains and not retroactively and arbitrarily converted in substantial part to ordinary income.

Apparently, at the last minute, Congress became aware of the hardship of the new imputed interest and original issue discount rules as applied to the sale of residences (where many sellers may be forced to carry back a second mortgage) and to the sale of farms which are frequently financed by the seller. We firmly believe that Congress, in adopting Paragraph (23) of House Concurrent Resolution 328, intended to exempt farms from the application of these new rules regardless of the selling price. However, in drafting the provisions of the Concurrent Resolution, only §483 dealing with imputed interest was

amended. I am advised that it was also necessary to amend §1274 (the original issue discount section), but this was not done.

I think we have a classic hardship case justifying (a) grandfathering our transaction from the retroactive application of the new law or (b) exempting from the new §483 and §1274 rules all sales of farm land regardless of the time of sale and the selling price. I urge Congress to continue the old §483 rules in effect for the pending sale of our farm land and all other sales of farm and ranch land.


FORT COLLINS
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Mr. LENTZ. Mr. Chairman, may I make just one remark?

Senator PACKWOOD. Yes, sir.

Mr. LENTZ. I am Mr. Deines' lawyer on this matter. The thing that bothers me about his situation is simply this: Congress said that these new rules would not apply during 1984; you could make a transaction on December 31, 1984, knowing the new rules, knowing you were going to get ahead of the new rules, close it in 1984, and you would be under the old law.

Deines made a contract, a binding contract, in April of this year with a delayed closing date into 1985. He is stuck. And that simply doesn't seem right to me. It seems to me that if you had a contract prior to the time the law was adopted, that ought to be under the old rules; it's just that simple.

Senator PACKWOOD. The problem you mentioned is one this committee and Congress faces perpetually, because almost any time we pass a tax law with an effective date—I think Mr. Deines' problem is a genuine and legitimate problem—we will say the effective date is September 1, December 1, February 1. And somebody has signed a contract, but it doesn't go into effect until afterward, or it is not fully completed until afterward. And in many cases, we try to do justice by taking care of very specific situations. But I think we have discovered that no matter what date we pick, we catch somebody who has not totally consummated a contract, but has, perhaps, signed it prior to the date. And we honestly try to take care of those, and we do so sometimes on a one-by-one basis where we think we have not done equity.

Bob?

Senator DOLE. I would just say, along that same line, I think we will ask Treasury to take a look at this. It seems to me that you have made a good point; it doesn't seem to be a fair way to treat that particular transaction.

I don't have any questions. I know the witnesses here obviously have a different view than Treasury or we wouldn't be having the hearing.

So, what I am going to suggest is that maybe we try to get Treasury to sit down and take another look at it, in view of the statements that have been given. I assume that there are some areas that ought to be addressed.

Again, I know that Senator Melcher can harass me on the debt ceiling and everything else between now and the end of the year, and he probably will. He doesn't mind doing that. [Laughter.]

But that isn't going to get it passed. It seems to me if we want to try to work out something and get it done, we'll attempt to do that. If it is reasonable we will ask the joint committee for their input as well as Treasury, but we have this one problem that Senator Long understands better than I do on the Senate side, and Senator Packwood and others: You put out one little tax proposal there, and you get about 500. I already know of four or five. I can count four or five without leaving this room that would like to be added to one little package.

Senator PACKWOOD. I've got two.

Senator DOLE. I know Bob has two—legal and education.

Senator PACKWOOD. Yep.

Senator DOLE. A little fringe benefit right before Christmas, or before the election. [Laughter.]

Senator PACKWOOD. Isn't that Christmas? [Laughter.]

Senator DOLE. But, in any event, we appreciate your coming, and we will look at this seriously, and particularly the problems you raise, Mr. Deines.

Senator PACKWOOD. Mr. Treadwell?

Mr. TREADWELL. Let me just comment, in support of Mr. Deines, that we have seen the same problem and suggest that perhaps if the Treasury looked at it as the date that a binding contract is formed. If there is going to be a sliding rate, of course, it makes a serious problem if you don't do that, because many transactions are delayed 6 or 8 or 10 months.

Senator PACKWOOD. There must be hundreds of transactions where you would in essence have consummated the contract but haven't quite completed it, I assume.

Mr. TREADWELL. If we had "a binding contract," rather than "the date of closing," I think that would solve that problem.

Senator PACKWOOD. Russell?

Senator LONG. No questions, thank you.

Senator PACKWOOD. Steve?

Senator SYMMS. Thank you, Mr. Chairman.

And I want to thank you for having the hearing this morning. I am very interested in this issue, and, as you know, I have introduced a bill that directly speaks to this. I understand Treasury is not in favor of it, and I appreciate Senator Dole's statement that hopefully we can get them to take another look at it to see what can be worked out, because we do, I think, have a problem in the agricultural States with what was done with respect to this in the last tax bill. I think we have just got to take a re-look at it, because I think there is a problem here that is going to interfere with people's ability to sell their property for a fair price, and also to keep their equity in balance when they go into the bank to borrow money. We've got to work that out some way.

So, I hope we can continue to explore this. I thank you for having the hearing, and I am going to continue to pursue this. I will review the testimony this morning. I am sorry I missed the first part of the hearing, but I am going to review the record. I am very interested in the issue.

Senator PACKWOOD. I think I can assure all of the witnesses that we got into this unintentionally, and it was not until late in the hearing when this little 2-inch article appeared in the Wall Street Journal in that kind of summary column on the front page calling attention to this. And we did not realize the unintended damage we were doing. We knew the abuse we wanted to cure—and there is a genuine abuse by people who take advantage of it—but I don't think we realized the unintended consequences.

Chuck?

Senator GRASSLEY. Well, Senator Jepsen and I have been concerned about this over a long period of time. And as I indicated in earlier testimony, maybe the reason it floated by so easily is because, to a great extent, we felt that the problem had been solved with an earlier effort by the Treasury Department to change the policy on imputed interest.

But from a practical standpoint, I guess this is the way I would look at it: You could have $2,000 farmland in the State of Iowa that, if it were sold on even a 10-percent contract, it would be $200 a year just in the yearly cost of the land. That land today would cash rent for maybe $130 to $140 an acre. And it seems to me like we have to take into consideration the cash flow in agriculture. I don't mean to always cry that agriculture has got to be treated differently, but we have tended to look at return on land at a lower rate of interest than we have a lot of other returns on money. Why? I don't know. It is just a traditional, historical thing. And particularly right now when we have such a hard time in agriculture with even cash rent going down as a result of it, it seems to me like we can't be here in the Congress mandating that some higher rate of interest is being charged, because there just is not going to be any change of land. And one of the things we want to do, particularly within families, but that is even getting difficult, is to be able to pass on from people who believe in the family farm situation who aren't necessarily just interested in getting money into their pockets. They want to transfer on to somebody else and a younger farmer hopefully the ability to keep the family farm going, even if it is not somebody in the family. There are people who have an altruistic reason for maybe accepting a little less return on their money. It has been a normal way of life. I mean, the farmers of this country already are supporting the consumer's food bill of this Nation by 40 percent and have been doing it for two decades. It is something that we accept.

It seems to me like to some extent we have to look at agriculture a little bit differently than maybe some of these other real estate contracts. Maybe there is no legitimacy for it, but, if there isn't, then we've got to bring the other sorts of contracts in line with agriculture, because we can't jeopardize that sort of situation that I think is economically sound, based upon tradition and historical perspective.

It seems to me like the IRS regulations and now our law are going to have to be changed to recognize what has been a traditional approach to a large segment of our economy.

Mr. KOELEMIJ. Mr. Chairman?

Senator PACKWOOD. Yes, sir.

Mr. KOELEMIJ. May I bring you one little example that I think would demonstrate, to really take issue with what the Treasury Department is saying, that their imputed rate is a market condition?

Senator PACKWOOD. Go right ahead.

Mr. KOELEMIJ. I am involved in the purchase of a shopping center—it is being closed today or tomorrow. The purchase price was $2.5 million, and we are making a $1 million downpayment.

The bank involved in the financing of this project had a 9.25-percent loan. They have agreed to extend that loan for 3 years at a rate of 11 percent, 2 years after that at a rate of 15 percent, at which time it is to be renegotiated.

Now, the property was somewhat neglected, and these are economic conditions that make them believe that this is a reasonable rate for them. For us, it is the only way to do that, because otherwise the cash flow would not support the undertaking of this

project, to rehabilitate it, and to sell it off as a condominium later on.

Senator PACKWOOD. Those are exactly the kinds of examples we need.

Mr. KOELEMIJ. I would be glad to submit it, if you like.

Senator PACKWOOD. You just did, and we've got it.

Mr. KOELEMIJ. Thank you.

Senator PACKWOOD. Gentlemen, thank you very much.

Mr. Deines, thank you for coming.

Mr. DEINES. Thank you.

Mr. TREADWELL. Thank you, sir.

Senator PACKWOOD. The hearing is adjourned.

[Whereupon, at 11:30 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

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Secretary
Danny L. Brown
Chairman of the Board
Camp Coast to Coast
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STATEMENT

on

IMPUTED INTEREST ON DEFERRED PAYMENT
SALES OF PROPERTY

on behalf of

AMERICAN LAND DEVELOPMENT ASSOCIATION

presented to the

SENATE TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE

by

ROBERT D. GROSSMAN, JR.
GROSSMAN & FLASK, P.C.

August 3, 1984

TELEX: 908248 TELEX SVC ECTY

Mr. Chairman, the American Land Development Association (ALDA) is pleased to present its views on the changes effected by the recently enacted Tax Reform Act of 1984 to the imputed interest rules of section 483 of the Internal Revenue Code of 1954, as amended ("Code"), and new Code Sec. 1274, relating to original issue discount ("OID") arising from debt obligations issued in exchange for property. More specifically, Mr. Chairman, we urge you and the other members of the Subcommittee to extend the exception from those provisions currently provided for the sale of principal residences to residential investment property in general, including second or vacation homes.

By way of background, the American Land Development Association represents leading national, and international companies which develop recreational, resort, and residential real estate, including vacation homes, condominiums, resort timesharing, planned unit developments, new and retirement communities, mobile home parks and recreational vehicle parks and campgrounds. Our membership includes both real estate development subsidiaries of major corporations as well as smaller privately held development companies.

I. BACKGROUND

In order to avoid the new OID and imputed interest rules, a debt instrument given in consideration for the sale or exchange of non-cash property such as real estate must provide for the current payment of interest at a rate equal

to at least 110% of the applicable federal rate (compounded semi-annually). Based on current market rates for U.S. Treasury obligations, that almost certainly will translate into a required interest rate in excess of 15% for mid and long term obligations incurred today. On that basis, any mid or long-term debt instrument that fails to satisfy the 110% rule would be subject to imputed interest at a rate in excess of 16.3%! By contrast, immediately prior to the passage of the Tax Reform Act of 1984, the applicable rates were 9% and 10%, respectively. The new rates are scheduled to take effect on January 1, 1985.

In recognition of the potentially devastating effect that such increased rates would have on the sale of property subject to the new rules, Congress has provided a well reasoned and most compelling exception for sales of principal residences. Such sales are <u>not</u> subject to the new OID rules but rather are subject to the new imputed interest rules only to the extent that the purchase price exceeds $250,000. To the extent the purchase price does not exceed $250,000, the sale is governed by the "old" imputed interest rules.

II. PROBLEMS WITH CURRENT LAW

We have all become acutely aware that it is extremely difficult to buy or sell a house when interest rates are high. Without so-called "creative financing," which generally involves below-market loans from the seller, many if not most such sales would not occur. Normal commercial

lenders simply will not provide the necessary financing flexibility. This is even more true of sales of investment properties, including second or vacation homes. Commercial mortgages for such property generally carry higher interest rates because the properties will not be owner-occupied.

Thus, creative seller-financing (which the new OID and imputed interest rules specifically discourage) plays an even more important role in the sale of such property. In short, the new law rewards big bankers by eliminating seller financing competition, just the opposite of what Congress and the people would want.

The new OID and imputed interest rules, if allowed to take effect, would effectively eliminate seller financing to the joy of the big institutions and to the regret of buyers and sellers. As a result, sellers will be unable to sell and and buyers will be unable to buy such property. But the individual sellers and buyers will not be the only victims. The loss of taxable sales will result in a loss of revenues. Thus, rather than increasing overall revenues, the new OID and imputed interest rules will more likely decrease them! Even worse, the elimination of below-market seller financing in times of high interest rates could cause interest rates to rise even higher because prospective buyers would be forced to compete in the general credit market for funds with the federal government

and general commercial borrowers. Thus, the economy as a whole is likely to suffer.

In addition to inhibiting the free transfer of property, the new OID and imputed interest rules are also inordinately difficult to understand and administer. They involve accounting concepts, such as "economic accrual of interest", that are foreign to the average taxpayer. As a result, they present a trap for the unwary. They necessarily overstate and distort the income of a seller who is on the cash basis of accounting by forcing him to recognize "phantom income" in the form of accrued but unpaid interest.

They represent an additional layer of complexity that invites administrative error, and requires taxpayers to incur additional costs in order to insure compliance. Finally, in the case of real estate, the new rules would violate the laws of many states, including New York and Illinois, which do not allow the compounding of interest rates of sales of real property.

The new OID and imputed interest rules are apparently designed to eliminate transactions that are artificially structured to accelerate interest expense deductions and increase accelerated cost recovery deduction and investment tax credits. In the process, however, they unnecessarily disrupt legitimate, economically-motivated transactions involving the sale of real estate. This unintended result was recognized and corrected by Congress when, with good and

proper reason, it enacted the exception for sales of principal residences. Those same reasons apply with equal or greater force to the sale of residential property in general. In targeting a perceived abuse which current Code Sec. 446(b) effectively eliminates anyway, the new law is like trying to kill a house fly with an atomic bomb. The result is devastating.

CONCLUSION

The American Land Development Association therefore proposes that all (not just principal residence) real estate sales should be exempted from the new OID and imputed interest rules. We look forward to prompt congressional action on this most important issue. Please do not hesitate to contact us, specifically, Thomas C. Franks, Vice President of Government Relations, (202) 371-6700, if you have any questions.

August 22, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Reaction to 1984 Tax Reform Act

Dear Sir:

I wish this letter to be included in the printed record of the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

By means of this letter I wish to relate my concern for the unfavorable consequences to be realized out of the passage of the above act, especially as it relates to the imputed interest rules pertaining to real estate transactions.

I am a licensed commercial real estate broker in the State of Colorado and deal regularly with transactions which involve seller (carryback) financing. My concern is that this new tax law has incorrectly addressed some of the common abuses of the past which this law has attempted to correct.

Seller financing, in my opinion, has typically represented a truer interest rate than that which is reflected in current commercial paper markets. The seller financial rate is tied to an individual's perceived value of an "adequate return" or alternatively, an individual's "opportunity cost" of capital. In these types of transactions, a seller is not concerned with a commercial "cost of funds" index, nor should he be!

It is inconceivable to me why and how our society consisting of individuals operating with their own assets should be governed by a federal index. The increasing errosion of our "laissez faire" system alarms me dramatically.

Additionally, seller financing tied to a federal index fails to recognize the marked distinction between the cost of doing business for an individual versus a commercial lending institution. There is no reason why an individual needs to charge the "additional" interest on top of "an adequate return" which is required by commercial lenders to cover their operating overhead. The result is to further establish an inflationary basis to our economic system that continually is being expanded. Under the present system, what is

often the case in both large and small real estate transactions is to combine institutional financing with seller financing to creata a "blended rate" which is more representative of a true interest rate.

In summary, the end result of the new tax law, in my opinion, is that it creates increasing inflationary bias to our economic system; will restrict, if not totally eliminate, the economic justification for a significant number of real estate transactions; and lastly, fails to properly address the clear distinctions between owner financing and commercial lending as a means of accomplishing real estate transactions.

I encourage, along with all individuals involved in the real estate industry, your review of the current tax law so that it properly addresses the concerns which we all share - to promote a fair and healthy economy.

Very truly yours,

Paul L. Anderson
Broker Associate

dds

STATEMENT OF

THE BOWLING PROPRIETORS' ASSOCIATION OF AMERICA

BEFORE THE

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT

ON

ORIGINAL ISSUE DISCOUNT AND IMPUTED INTEREST RULES

August 3, 1984

Washington, D.C.

Mr. Chairman and Members of the Subcommittee:

My name is Ruben Dankoff and I am Chairman of the Legislative Committee of the Bowling Proprietors Association of America. I also own and operate the General Bowling Corporation, 203 Leroy Street, Tenafly, New Jersey. The Association thanks the Chairman and the Committee for the opportunity to present its concerns regarding the unnecessary sweeping changes contemplated in the new imputed interest rules contained in the Tax Reform Act of 1984.

The Bowling Proprietor's Association is headquartered in Arlington, Texas, and has a membership of over 5,000. In regard to financial investment and in the fiscal operations of the individual proprietor, our members are most representative of the class of American entrepreneurs called small businessmen. We operate on a small margin, we meet our payrolls, and we pay more taxes to the United States and the state governments than any other class or group in American society.

We are represented here today to express our concern in regard to various imputed interest provisions of the recently enacted Deficit Reduction Act of 1984, and to support the efforts of those members of the Congress who are seeking to repeal these poorly reasoned provisions. In regard to the interest rate requirements of this Act, we surmise that they would have relatively little long-range impact on big business--for the small businessman they are a disaster.

In the case of a small business, the buyer normally is either another small business, an individual of limited means, or a group of individuals who have limited cash and little ability to borrow funds. Buyers of this type can't pay all cash. Just about the only way a small business can be sold is if the seller holds a note/purchase money mortgage for a substantial portion of the price. Since small businesses are difficult to sell in any event, frequently it takes the inducement of an attractive rate of interest to convince a buyer to go forward.

Take, for example, the owner of a small business that also owns its land and building. It would be quite common for that business to be sold on the basis of 20% down at closing with the seller holding a note for the balance at, say, 11% interest over 10 years. The buyer then is able to pay for much of the purchase out of the revenues of operating that business over the years. Thus, the seller's willingness to finance the sale at a fixed and attractive interest rate for a longer period of time than banks offer helps facilitate the sale.

On the other hand, under the new law, because 10-year T-Bills now sell for about 12.5%, the seller's note would have to carry interest at 13.7%, a rate which would discourage many prospective purchasers of small businesses. At rates like those, many small businesses simply can't be sold.

Therefore, we could well see cases in which the proprietor of a small business (manufacturing plant, retail store, restaurant, motel, bowling center, etc.) has worked his whole life to build up his business and then when the time comes to sell it, he is unable to do so because of a burdensome tax law.

We in the bowling industry bear yet an additional burden which will be greatly intensified under this new law. Banks are reluctant to lend money to finance the acquisition of bowling centers; the industry still bears a taint in the financial community from the collapse of bowling in the early 1960's. Bankers further perceive bowling centers to be single purpose buildings, which they feel are impossible to adapt to other uses should the mortgage be foreclosed. Thus seller-financing is necessary to sell a bowling center and sales for all cash are virtually unheard of in the bowling industry. This new law would work a particular hardship upon bowling proprietors.

Congress granted an exemption for the sale of farms up to $1 million presumably for reasons similar to those that also apply to the sale of small businesses. It would seem only fair that because they are in the same position and bear the same

handicaps, sales of small businesses up to $1 million also should be exempt from the new interest rate rules.

We do not contend that the adverse effects of this legislation are limited to our industry, or even to a significant sector. The adverse effects encompass all small business. To recognize the scope it is important to realize that seller financed installment sales of property has become the increasingly popular alternative to commercial financing. Time as well as money is the primary factor in the sale of a small business. People dealing at arms length in such transactions have traditionally negotiated interest rates at less than commercial rates solely for the purpose of effecting a sale.

During periods of high interest rates privately financed sales of property and small business constituted the only way this type of commercial sales could continue. These private negotiations featuring attractive seller financing at varying reduced rates have not only been the key to conducting business during these periods, but have further attracted additional monies into the marketplace and has served as a catalyst to bring commercial loans into line. The proposed action by the Internal Revenue Service mandated under these sections of the Act will totally negate this triggering mechanism so vital to the economic stability of the country. These new rules would impose upon a private transaction a system of tax accounting for interest and principal payments which would be, more often than not, different from the interest and principal payments which the

parties contemplated in entering the transaction. It would bring a great number of proposed sales to an immediate halt. In many instances, principal would be recharacterized by the Revenue Service as interest and thereby become income to the seller. The attractive seller financing which induced the sale is altered by government fiat from a contemplated long term capital gain into tax producing income.

Because of the presence of harsh and repressive results, which we are sure Congress did not contemplated in passing the 1984 Tax Act, we strongly urge this Committee to consider favorably an exemption for small businessmen selling real estate up to $1 million or at least $750,000. We also wish to note our support of H.R. 6021 and the Bill submitted by Senator Melcher directed toward diminishing the negative impact of this section of the '84 Tax Act.

Concommitant with the adverse effect the imputed interest provisions will have on our industry, I would direct the Sub-Committee's attention to that section of the Act allowing recapture on installment sales. Every bowling center in this country is equipment-intensive and incurs substantial depreciation charges on its equipment. As you know, Mr. Chairman, under applicable law and regulations, when a bowling center is sold, all of the depreciation comes back as ordinary income via recapture. This alone is an excessive burden and a sales deterrent. However, the new Act, by making all of the tax payable at the closing of the

sale, has been a catastrophe to the bowling industry and similar small businesses that are traditionally sold on an installment basis.

We will be constantly faced in our industry with sales situations wherein the initial down payment constitutes a mere fraction of the federal taxes due and payable at the time of the sale. Tax demands that the seller cannot meet. We would have a sale, agreeable to the seller and to the buyer, but a sale that by government fiat, cannot be consummated.

I realize Mr. Chairman, that this section of the Act was not originally projected as a subject for consideration during this hearing. I would, however, request that this serious matter terribly damaging to our industry, would receive your concern in order that potential future damage could be avoided.

Thank you for the opportunity to present our views.

August 21, 1984

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Gentlemen:

I would like to have this letter included in the printed record for the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

I feel that the New Code Section 1274 enactment has created an extremely complicated and unmanageable situation for not only attorneys, but the average taxpayer. This new enactment has become an issue whereby no one, but possibly a C.P.A. can understand its effects primarily in the area of the sale of real property. Taking into account the imputed interest rules of Code Section 483 and how difficult this tax law was to understand, New Code Section 1274 has not helped the average taxpayer understand any better how the tax laws work, and if they are a benefit or not to his certain situation.

In dealing with the mechanics of real property transactions, the complicated rules of Section 1274 could be followed exactly prior to closing, however, if interest rates change in the interim, this change could cause the transaction to no longer comply with Section 1274, and thus resulting in a penalty to the seller, who thought he was complying with the law when he signed the contract. Obviously, when Congress enacted Section 1274, they did not understand the logistics of real estate.

As you can see, Congress has created a "monster". Taxpayers who are entering into real property transactions which result in contractual agreements, have no way of determining the tax consequences of such transactions under Section 1274. To force a seller and commercial lender to a real estate transaction to charge a rate of interest greater than treasury rates or commercial lending rates is a highly inflationary measure, especially in land transactions that eventually end up as subdivided home sites which reflect a higher carryback interest rate in the final home site sale to the consumer. Such a law is counterproductive to Congress' intent to reduce inflation. What this country does not need is higher priced housing and a higher cost of doing business!

If Section 1274 cannot be repealed, and it should be, then the testing rate should be reduced to 80 percent of an appropriate treasury note yield (which would be approximately the NOW account rates) and the penalty rate should be equal to the appropriate treasury note yield. Furthermore, and most importantly, the rate should be the applicable rate at the date the contract is entered into, not the date of the closing of the real estate transaction.

I think it is most important for Congress to understand that by changing the rates really has no appreciable effect on government revenues. Under Section 483 and 1274, to the extent the seller's interest income is increased, the buyer's interest deduction is also increased resulting in no gain to the treasury. In other words, for each dollar of interest income, there would be a matching dollar of interest deduction.

Very truly yours,

John R. Bitzer
2601 South Quebec, #5
Denver, Colorado 80231

cag

c: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart
Congressman Hank Brown
Congressman Ray Kogovsek
Congressman Ken Kramer
Congresswoman Patricia Schroeder
Congressman Timothy Wirth

August 27, 1984

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

I would like to have this letter included in the printed record for the hearing on the changes to the imputed interest rules of Code Section 482 and New Code Section 1274.

This particular section has created a very unmanageable situation to an area of the tax law that is much too complicated anyway and in fact is going to penalize the sellers of real property. In most real estate transactions there is a time period that elapses between entering into the contract by all parties concerned and the actual closing of the transaction and/or the transfer of the deed. This elapsed time, in some cases, is as long as six months or more and it is very difficult to guarantee what the treasury bill rate will be in that period of time. This is an example of the unknowns that will tend to hurt real estate transactions and prevent them from taking place. In explaining further, it is because of this time lag a contract could be entered into complying with Section 1274 and prior to closing the interest rates could change causing the transactions to no longer comply with that section, thereby accessing a penalty against the seller of the property who thought he was complying with the law when he signed the contract. This is very unfair and will be unmanageable and will cause fewer transactions or sales of real property to take place thus cutting back on the growth of our economy. In the past, real estate transactions have always been a matter of supply and demand. Owners have carried paper or carried the loan and received payment in order to make something happen. This will now be unmanageable and therefore will not take place.

In essence, I would like to express my dissatisfaction with Section 1274 of the new code of the Internal Revenue Service.

Sincerely,

William P. Brougham
4517 South Lowell Boulevard
Denver, Colorado 80236

c: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart
Congressman Hank Brown
Congressman Ray Kogovsek
Congressman Ken Kramer
Congresswoman Patricia Schroeder
Congressman Timothy Wirth

BOMA INTERNATIONAL

BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

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Executive Vice President

STATEMENT OF THE

BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

ON THE

TREATMENT OF INTEREST ON

DEFERRED PAYMENT SALES

OF PROPERTY

SUBMITTED BY

NOEL R. LEARY

EXECUTIVE VICE PRESIDENT

TO

THE SENATE FINANCE SUBCOMMITTEE

ON

TAXATION AND DEBT MANAGEMENT

August 3, 1984

COUNSEL:
WINSTON & STRAWN
EDWARD C. MAEDER
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The Building Owners and Managers Association International ("BOMA") is an association of over 5,000 owners and managers of commercial office buildings containing nearly two billion square feet of space. BOMA members also own or manage other types of commercial real estate as well as residential rental property.

BOMA congratulates the Senate Finance Subcommittee on Taxation and Debt Management for convening this hearing on the imputed interest rules of the Tax Reform Act of 1984 (the "Act"). BOMA believes that Congress did not analyze these provisions in sufficient detail when the Act was under consideration, and it urges the Subcommittee to use this hearing as an opportunity to make significant changes.

The immediate reaction to the new rules has focused primarily upon the impact on sales of residences, farms and small businesses. A significant number of BOMA members represent small and medium-size commercial and residential properties. As a result, BOMA strongly supports changes in the imputed interest rules that deal with small business and residences. BOMA urges the Subcommittee to act favorably upon the bills introduced by Senator Melcher (S. 2894) and Senator Symms (S. 2815) that establish much broader exceptions for small business and residential property sales.

BOMA supports with equal strength, however, the need for a complete review of new rules on imputed interest in

deferred payment sales. These new rules contain fundamental problems that effect major segments of the commercial real estate industry that do not fall within the exceptions for a certain set of transactions. It is imperative that the Subcommittee deal comprehensively with the new rules and not limit itself to correcting the obvious hardships related to small business, residences, and farms.

The new rules for imputed interest were formulated on the basis of a highly theoretical economic analysis of deferred payment transactions. Like many economic theories, the variety of practical problems that occur in the real world of commercial real estate finance and the theoretical problems contained in the economic model are often entirely different.

The goal of the new imputed interest rules is to require symmetry in the treatment of items of income and expense by payors and payees. Symmetrical treatment is, however, not appropriate and often harmful in a wide variety of real estate transactions. For example, symmetrical treatment of items of income and expense does not necessarily make sense when the payor of the interest is not the original issuer of the obligation, as is often the case in a real estate transaction. Symmetrical treatment of income and expense items works a serious hardship on property owners trying to negotiate the deferral of payments to creditors and other suppliers because they are experiencing financial difficulties. Creditors and suppliers are much less

likely to agree to deferral if they will have to pay tax on the deferred payments according to the imputed interest rules.

The new imputed interest rules also retroactively reduce the value of property currently held and make its sale more difficult. Property owners will be forced to demand additional and unforeseen amounts of cash to pay taxes on the sale of their property. If an owner fails to obtain the cash or a buyer cannot provide it, the owner must pay tax on phantom income. In addition, property owners will be discouraged from providing incentives to sell their property to such higher risk buyers as first-time commercial property buyers.

As a result, property owners are penalized twice: first, the value of their property is reduced; and, second, their pool of potential buyers is reduced. BOMA suggests that it is not in the best interests of the United States economy to adopt policies that make it more difficult for current owners to transfer their property. Such policies interfere with the efficient allocation of capital and distort the commercial real estate market.

Thus, BOMA believes the Congress should do more than pass S. 2894 introduced by Senator Melcher or S. 2815 introduced by Senator Symms. BOMA also urges the Congress to act favorably upon a second bill introduced by Senator Symms (S. 2930) that repeals entirely the recently enacted rules on imputed interest

and restores the rules that existed prior to enactment of the Tax Reform Act of 1984.

Even if Congress is not prepared to repeal the new rules, it must reduce the current testing rate of 110 percent of the applicable federal rate and the imputed rate of 120 percent. These rates do not bear a rational relationship to the rate of interest freely negotiated at arms' length between a willing buyer and a willing seller.

The testing and imputed rates should be lowered to 80 percent and 110 percent respectively. The purpose of a testing rate is to establish a floor that allows for negotiations between the parties, but does not allow them to establish artificial rates for tax avoidance purposes. The purpose of the imputed rate is to penalize taxpayers who refuse to abide by the testing rate. The testing rate in the new rules imposes an arbitrary number between the parties that allows no flexibility. Rates of 80 percent and 110 percent represent a significant increase in the rates currently charged in many real estate transactions because they are compound rates rather than simple rates, but they are more appropriate for a testing rate and an imputed rate than the new rules.

The effective date of the new imputed interest rules has been postponed until January 1, 1985, in order to give taxpayers an opportunity to react to these extraordinarily complex changes. The degree of controversy that has been

generated in the seven weeks since the rules were enacted demonstrate the urgent need for change. Congress must address the entire question of imputed interest before the January 1 effective date so that investors in and managers of commercial real estate can make reasoned decisions in planning for 1985.

40-276 O—84——10

Tax Reform Act of 1984:
Its Impact on Housing and Real Estate in California

Testimony Submitted by the
California Association of REALTORS®
as part of the
Senate Committee on Finance Hearings
August 3, 1984

Tax Reform Act of 1984:
Its Impact on Housing and Real Estate in California

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California Association of REALTORS®
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The Tax Reform Bill of 1984 contained provisions that significantly affect real estate financing and that adversely impact upon the real estate and housing marketplace in California. Those provisions impacting the minimum and imputed interest rate and original issue discount (OID) rules are by far the most detrimental, despite the exemptions provided in the technical amendments for certain principal residences occupied by the seller. Original issue discount means that for tax purposes, the lender in a transaction is treated as having received the interest on an obligation, even if it is not yet actually paid or received, and sets a minimum interest rate for figuring the amount of interest income to be taxed. Prior to enactment of the Tax Reform Bill, OID rules did not apply to obligations issued by individuals or issued in exchange for property. Under the new imputed rate rules, the minimum rate which must be charged on seller financing of certain types of property must equal 110 percent of an applicable federal rate, or interest will be imputed for tax purposes at 120 percent of the federal rate.

The rules, in effect, will increase the costs of mortgage capital provided by sellers to individual homebuyers and other residential and real property investors, by raising the minimum required rate on such financing above the current 9 percent. **Thus, the new rules will increase housing costs to homebuyers as well as renters.** The detrimental effects of these higher mortgage capital costs will be seen in a **loss of housing and other real property transactions, a loss of economic activity and governmental revenues at all levels and increased housing costs to both buyers and renters.**

For the reasons outlined below, **the California Association of REALTORS®** -- a trade organization representing over 100,000 real estate licensees in the state of California whose business involves helping buyers locate alternative sources of mortgage financing -- **urges Congress to provide exceptions for all real property transactions from both the original issue discount and imputed interest rules, with those exceptions which existed prior to the Tax Reform Act.** Prior to the Tax Act, the law required most seller financing to be written at an interest rate of at least 9 percent, or else interest would be imputed at a 10 percent rate for federal tax purposes. Moreoever, we believe that regulatory action in this area should not attempt to achieve what could not be achieved through legislation, by increasing the minimum and imputed rates above the 9 and 10 percent thresholds, respectively.

The Association, however, is most concerned with the impact of the tax rule changes on residential property transactions. Thus, in the event that exceptions for all real property are not feasible, **then we would urge that exemptions for the purchase/sale of all residential (including residential income) property at least be provided.** Along those lines, we would also urge that other real property up to a purchase price of $5 million be exempted. For non-residential properties sold for more than $5 million, no more that 100 percent of the applicable federal rate should be applied for imputation purposes in contrast to the 120 percent rule included in the recent tax bill. The minimum required or safe harbor rate should be calculated at 80 percent of the applicable federal rate, but at no more than 90 percent of the federal rate.

The Role of Seller Financing

Seller financing has played a critically important role in the California resale housing and real estate market since 1980. In fact, during 1981 and 1982, sellers became the primary source of real estate mortgage financing as a result of the virtual withdrawal of institutional mortgage lenders from the marketplace. In residential transactions, sellers provided the bulk of this financing at interest rates substantially below that which otherwise would have been required under the imputed interest rules included in the tax bill. In the absence of those rules, sellers were able to provide the **only source of affordable financing for hundreds of thousands of households** during the recession when institutional mortgage interest rates were in the range of 16 to 17 percent.

These sellers **do not provide financing for tax avoidance purposes** for which the tax legislation was originally proposed. **Instead, the mortgage loans they provide address the critical housing affordability problems that California homebuyers face** and thus, merely facilitate the sale/purchase of a home. **Nor do sellers receive substantially higher prices for homes they finance.** Previous studies by economists at the Bank of America, UC Berkeley, and other researchers have shown that below-market seller financing enhanced aggregate California home prices **by only a margin of 3 to 5 percent during 1980 through 1982.**

Role of Housing in the Economy and Impact on Tax Revenues

The new tax rules will force the cost of mortgage financing higher -- especially during periods of higher interest rates when other lenders have in effect withdrawn from the market -- causing a loss of resale activity and as a consequence, declining general economic activity and governmental tax revenues. The housing sector plays a pivotal role in the California and U.S. economies: in addition to the direct economic value generated, housing activity has significant indirect economic impacts and generates substantial federal, state and local tax revenues. Both new construction and resale housing output totaled 14 percent of California's gross state

product in 1983. Additionally, local and state tax revenues generated by the housing industry in California equalled $3.1 billion in 1983. Both the direct economic benefits and the tax revenue generating capabilities of housing and real estate activity, however, have been jeopardized as a result of the Tax Bill provisions.

Tax Bill Impacts on Housing Costs

The higher interest rates imposed on seller financing under the new imputed interest rate rules will significantly drive up the cost of housing. Currently, the higher rate required under the imputed interest rules would increase average monthly housing costs by between 15 to 25 percent for those homebuyers not otherwise exempted under the rules. Because **some 25 percent of all resale housing transactions, and all of the new housing sales, are not exempt in California,** imposing such a substantial increase in monthly home financing costs will force tens of thousands of potential homebuyers in California out of the marketplace.

Most unfairly impacted are the buyers of single-family homes where the seller was no longer the owner-occupant at the time of sale for reasons including divorce, employment relocation or death. These buyers -- many of them first-time buyers -- constitute nearly 22 percent of the state's resale market. They will face substantially higher financing costs, regardless of whether their home would otherwise have been exempted under the sales price exception provided in the new rules. The new tax rules also create hardships on sellers who take back financing and later find themselves initiating foreclosure on a unit for failure of the buyer to make the monthly loan payments--payments for which the seller, nevertheless, incurs a tax liability under the OID rules. Similarly, in distress sales, where the property is sold at a loss (or for less than was originally paid or financed) the seller retains liability for taxes due under the OID rules.

Not only will homebuyers face higher housing costs, **but so will renters under the new tax law.** The new provisions **impact virtually all residential income property transactions** -- including everything from duplexes to huge apartment complexes -- increasing debt servicing requirements substantially. Residential income property investors have depended heavily upon low-interest and deferred interest financing to make projects "pencil out" in recent years. Thus, the higher seller financing costs associated with the purchase of residential income property will, by necessity, be passed on to renters in the form of higher monthly rents. In those markets where these costs cannot be passed through to tenants, new construction and renovation of rental units will either cease or be severely curtailed. Ultimately, this decrease in the new supply of rental units will become a factor pushing rents even higher.

Commercial/Industrial Transactions

Finally, commercial and industrial property sales, particularly smaller properties such as strip center developments, depend heavily upon seller financing, and thus are impacted by the new rules. A slowdown in sales or new construction activity in this type of real estate will not only affect commercial and industrial investors, but **will directly slow general rates of economic growth.** Since affordable commercial and industrial space is necessary to continue the general economic expansion, a slowing of activity in this area will adversely affect economic growth and governmental tax revenues.

Conclusion

In summary, the new tax rules governing imputed interest and original issue discount have potentially significant and detrimental effects on the California real estate market. The higher mortgage financing costs imposed on seller-financing will depress housing and other real estate transactions. **These lower levels of activity will in turn reduce governmental revenues, substantially offsetting any tax gains generated by the new rules.** Additionally, the new laws increase housing costs for both buyers and renters, and impose burdensome tax liabilities on sellers who financed property and who must initiate foreclosure or sell the property in a distress sale. In doing all these things, **the tax bill impacts beyond the original legislative intent to close tax shelter loopholes.** For these reasons, changes to the new laws as specified above are urged.

COALITION FOR LOW AND MODERATE INCOME HOUSING

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August 17, 1984

STATEMENT
of the
COALITION FOR LOW AND MODERATE INCOME HOUSING
Regarding Reform of the Imputed Interest Rules
Submitted to the
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE
[Hearing Date: August 3, 1984]

The Coalition would like to thank the Subcommittee for this opportunity to express its views regarding the changes to the imputed interest rules of Section 483 of the Internal Revenue Code ("the Code"), and new Code Section 1274, relating to original issue discount ("OID") arising from debt obligations issued in exchange for property. Section 483 was amended and Section 1274 was enacted as part of the Deficit Reduction Act of 1984 ("the 1984 Tax Act"), which became law on July 18, 1984.

The Coalition for Low and Moderate Income Housing brings together in a single coalition all associations, trade groups, business organizations, and individuals, as well as associated professionals, involved in the private financing, production, rehabilitation, and operation of government-assisted low and moderate income multi-family rental housing. The Coalition works with the Administration, Congress, state governments, and others in an effort to promote the financing, production, rehabilitation and operation -- through private enterprise -- of low and

moderate income housing in the most effective ways possible. It is constantly seeking new and better methods for accomplishing that objective.

Congress is presently considering two principal pieces of legislation dealing with the amendments made by the 1984 Tax Act to Section 483 of the Code and with new Section 1274. H.R. 6021, sponsored by Congressman Archer and others would repeal all of the 1984 changes. S. 2894, sponsored by Senator Melcher and others, would amend the 1984 changes to exempt certain classes of transactions, primarily sales of real property used in a trade or business when the sale is incident to the sale of that business, sales of personal residences, and sales of small farms.

In principle, the Coalition supports the position of the Archer bill, that is, repeal of Section 1274 and of the 1984 amendments to Section 483. When these amendments were being considered, we, like many others, warned Congress over and over again that they would introduce needless complexity into the tax law; that they would have many unintended and unforeseen effects; and that they were not well thought out or well drafted. We urged that, before any such legislation was adopted, it should be thoroughly vetted by both the Congress and the private sector. We believe that our concerns are already beginning to be proven correct and that as time passes and the effects of these new provisions are understood by more and more affected taxpayers, the members of Congress will hear considerably more from their

constituents on this subject. Nevertheless, should Congress be unwilling at this time to repeal actions so recently taken, then prudence dictates that Congress should delay the effective dates of these changes until January 1, 1986, and, in the meantime, a careful analysis should be made of their real impact and an effort should be made to develop amendments that eliminate the complexity, confusion, and unintended consequences of the legislation so hastily enacted in 1984.

During the course of Congress' consideration of the amendments to Section 483 and of new Section 1274, the Coalition stressed over and over again the negative effects that these changes would have on the nation's stock of existing low income housing. We warned that these changes would contribute to the rapid deterioration of such housing stock; would accelerate defaults and foreclosures; and would ultimately impose a much greater cost on the federal government, because of the impact of such foreclosures upon the FHA insurance fund, then any possible tax saving. To be more specific, the Coalition estimated that if low income housing was exempted from the effects of new Section 1274 of the Code, the total federal revenues would be <u>enhanced</u>, during fiscal years 1985-1987, by a net <u>gain</u> of approximately $160 million.

The position of the Coalition, and the facts and figures to back it up, are set forth in Exhibit A attached hereto, a Fact Sheet made available to Congress on April 11, 1984. Nothing has changed with regard to the facts since that time.

On April 4, 1984, Senator Donald W. Riegle, Jr. wrote to Hon. Samuel Pierce, the Secretary of Housing and Urban Development, and asked for his views with respect to the then proposed changes to the original discount rules, as they might affect the nation's multi-family low income housing stock. More particularly, he inquired as to the accuracy of the revenue effect which had been submitted to Congress by the Coalition for Low and Moderate Income Housing.

Unfortunately, Secretary Pierce did not reply to Senator Riegle until May 22, 1984, well after the Senate had considered this issue. Nevertheless, Secretary Pierce's reply is most relevant. Secretary Pierce states:

> It is clear to me that the interests of the Department have benefited from many of the resyndications of subsidized limited dividend projects which have occurred since enactment of the Economic Recovery Act of 1981. Re-commencement of the tax incentives created for low-income rental housing at a point in time when those benefits have largely spent themselves provides an occasion for an infusion of necessary capital into a project.

Then, after a lengthy and somewhat inconclusive analysis of the effect of the OID changes and of the Coalition's revenue estimates, Secretary Pierce concludes:

> For the reasons stated above, therefore, we are not able to quantify with an acceptable degree of comfort the likely impact of the tax law change on the HUD-insured inventory. Nevertheless, it is clear that some transactions will be hindered and, more pertinently, that it is the transactions most likely to be able to advance housing objectives that are the most likely to be halted. The reason is obvious: any incremental reduction of available tax benefits will reduce the amount of cash that can be raised to meet project needs in addition to the private demands of sellers. Therefore, the transactions which would contribute the most toward project needs are precisely the transactions most likely to be halted by the tax change. (Emphasis added.)

The full texts of Senator Riegle's inquiry and Secretary Pierce's reply are attached hereto as Exhibits B and C, respectively.

When Secretary Pierce's letter is read in the light of the fact that his response was constructed, after very careful consideration, so that he would not in any way undermine the then still pending legislative efforts of the Treasury Department and the Administration with respect to the 1984 Tax Act, it is clear that the problems presented by Section 1274 constitute a clear and present danger to the nation's existing low income multi-family housing stock.

During the consideration of the 1984 Tax Act by the Senate, and after extensive negotiations with members of Congress, members of the Senate, the Joint Tax Committee, the Treasury Department, and the staffs of the House Ways and Means Committee and the Senate Finance Committee, the Coalition proposed an

amendment offered on the Senate floor by Senators Cranston and Riegle which would have had the effect of exempting, through December 31, 1985, low income housing from the effects of Section 1274. This exemption was very carefully constructed in order to prevent any abuses during this interim period. The drafting of this amendment was participated in by representatives of the Treasury Department, the Joint Tax Committee, and the staffs of the House Ways and Means Committee and the Senate Finance Committee (however, we do not mean to imply that any of these persons endorsed the amendment -- only that they agreed that if the amendment were adopted in the form drafted, it would avoid any abuses).

Despite the favorable votes of Senator Garn, Chairman of the Committee on Banking, Housing and Urban Affairs, and Senator Tower, Chairman of the Subcommittee on Housing and Urban Affairs, both of whom understood fully the implications of Section 1274 for low-income housing, the Cranston-Riegle amendment was tabled by the Senate because of the strong opposition of the Treasury Department and of Senator Dole.

Assuming that Congress is not disposed to adopt either (i) the Archer proposal of complete repeal or (ii) a deferral of the effective date of Section 1274 and the 1984 amendments to Section 483, then, in order to avoid a crisis in low income housing, Congress should reconsider the Cranston-Riegle proposal and Senator Melcher's bill should be amended to include an exemption,

through December 31, 1985, for low income housing. A copy of the text of the Cranston-Riegle amendment (with one change to correct a typographical error in paragraph 5 thereof) is attached hereto as Exhibit D.

Ignoring for the moment the net overall revenue gain to the federal government that the Coalition believes will result by virtue of this exemption (see Exhibit A), the tax loss involved in this narrow one-year exemption until the matter can be further considered is de minimus. Although it is almost impossible to calculate such loss correctly, the Coalition does not believe that it would be more than approximately $18 million.

If this one year exemption were allowed, time would be available for HUD and the private sector to develop a more satisfactory long-term solution to the problem which both the Coalition and HUD agree exists.

Thank you Mr. Chairman for the opportunity to present this statement. If you require further information, please contact either the counsel for the Coalition, Mr. Bruce S. Lane and Mr. Herbert F. Stevens, of Lane and Edson, P.C., at 202-955-9600 or Mr. Martin C. Schwartzberg, Chairman of the Coalition, at 301-468-9200.

Exhibit A

COALITION FOR LOW AND MODERATE INCOME HOUSING

FACT SHEET
April 11, 1984

2300 M Street, N.W.
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Telephone: (202) 955-9600

SENATE FINANCE COMMITTEE ERROR SERIOUSLY INJURES EXISTING LOW INCOME HOUSING STOCK

Problem: When the Senate Finance Committee adopted the Treasury Department's proposal changing the way deferred payments are treated under the Internal Revenue Code, [1/] the Committee made a serious error which will cost the Federal government a significant amount of money, and which will cause great harm to the nation's existing low income housing stock. If present law is not retained for low income housing, the federal deficit will worsen and many of the 6-7 million tenants of existing low income housing units across the country will be deprived of safe and humane living conditions. Here is why:

- At present, the only effective method for providing capital infusions for rehabilitation and preservation of existing low income housing projects is the transfer of the projects to a new group of owner-investors.

- This "equity refinancing" process will cease

  (i) because the new deferred payment rules will require the seller-owners to recognize taxable income each year without receiving cash to pay such taxes ("phantom income") (Both federal and state housing laws severely restrict cash distributions to owners of low income housing projects.); and

  (ii) because the new deferred payment rules, in the context of low income housing, greatly reduce the interest deductions to potential new owner-investors, thus encouraging them to divert their equity capital into less risky and more rewarding investments.

- If equity refinancing is stopped by the new deferred payment rules, many projects will fall further into disrepair, doing great harm to the tenants of low income housing. (Even sound projects presently will require, in the aggregate, $182,000,000 of repairs over the next three years.)

- In addition, the number of low income housing projects that will default on their mortgages will greatly increase. Since virtually all low income housing projects have mortgages held or insured by the federal or state governments - these mortgages are currently in excess of $25 Billion - this will mean a large direct cost to the federal and state governments when the mortgages are in default and are taken over by the government.

1/ See Senate Finance Committee Explanation of Provisions Approved by the Committee on March 21, 1984, Senate Print 98-169.

Other Senate Finance Committee Action Doesn't Help: The Senate Finance Committee thought it was protecting low income housing by retaining the present 15-year ACRS depreciation, but the change in the deferred payment rules overwhelms that benefit. Moreover, the exemption from the related party rules does not address or alleviate the problem created by the new deferred payment rules.

Solution: The simplest immediate solution is a short term exemption from these new deferred payment rules for low income housing. This will give Congress time to hold hearings to determine how to solve the problems of deteriorating housing conditions and large potential federal revenue losses from foreclosures of this housing. This exemption would contain a sunset of December 31, 1987.

The details of a proposed exemption are attached hereto as Exhibit A.

Anti Abuse Provisions: The attached proposal contains provisions worked out with the staff of the House Ways and Means Committee and others to prevent abuses and to ensure that the housing quality standards set by HUD are maintained.

Revenue Impact Of Solution Is Positive: HUD and the low income housing industry estimate that, based on the current rate of HUD project assignment and foreclosures, there will be a significant federal revenue gain from this exemption to the extent the federal insurance funds are not drawn upon. In FY 1985-1987 this is estimated to be over $360 million. This gain will overwhelm any tax revenue lost from the exemption -- estimated to be $200 million in FY 1985-1987. Thus, there will be a net revenue gain to the federal government from the exemption, after deducting the tax loss, of approximately $160 million during fiscal years 1985-1987.

The details of these revenue estimates are attached hereto as Exhibit B.

Broad Support for Proposal: The exemption is supported by the following groups who represent both tenants and private sector builders and owners of low income housing:

THE NATIONAL HOUSING PARTNERSHIP
COALITION FOR LOW AND MODERATE INCOME HOUSING
NATIONAL HOUSING REHABILITATION ASSOCIATION
NATIONAL LOW INCOME HOUSING COALITION
NATIONAL LEAGUE OF CITIES
NATIONAL ASSOCIATION OF COUNTIES
NATIONAL LEASED HOUSING ASSOCIATION
COUNCIL FOR RURAL HOUSING AND DEVELOPMENT
COUNCIL OF STATE HOUSING AGENCIES
NATIONAL URBAN LEAGUE
U.S. CONFERENCE OF MAYORS

For further information, please contact:

Bruce S. Lane, Esq.
Herbert F. Stevens, Esq.
Lane and Edson, P.C.
2300 M Street, N.W.
Washington, D.C. 20037
(202) 955-9600

Exhibit A

April 11, 1984

A Proposal for a Senate Amendment

1. Exempt low income housing from all of the provisions adopted by the Senate Finance Committee with respect to the treetment of interest attributable to deferred payments.

2. Low income housing is defined as property described in clause (i), (ii), (iii) or (iv) of Section 1250(a)(1)(B) of the Code.

3. Anti-Abuse Provisions -

   A. HUD, FmHA, or a State or Local Housing Agency must approve the transfer pursuant to laws, regulations or procedures governing the transfer of physical assets.

   B. Within 24 months after such transfer, (i) the new owner of the property must make all improvements to the property and meet all financial requirements called for by HUD, FmHA, or the State or Local agency as a condition of such approval; and (ii) the property must meet the housing quality standards prescribed by HUD for the Section 8 existing housing program.

   C. The property must have been owned by the transferor for at least 12 months, or have been acquired by the taxpayer pursuant to a purchase, assignment or other transfer from HUD, FmHA or any State or Local housing authority.

   D. Interest may not accrue for a period longer than 15 years, six months. If after this period, the accrued interest is not paid, all prior deductions taken for such accruals will be recaptured and taxed as ordinary income at that time.

   E. The rate at which interest may accrue may not exceed the IRS deficiency rate in effect at the time the debt is incurred, plus two (2) percentage points.

4. Sunset - This exemption will be applicable only to transfers which have occurred, or with respect to which a binding contract has been entered into, on or before December 31, 1987.

This proposal is supported by:

THE NATIONAL HOUSING PARTNERSHIP
COALITION FOR LOW AND MODERATE INCOME HOUSING
NATIONAL HOUSING REHABILITATION ASSOCIATION
NATIONAL LOW INCOME HOUSING COALITION
NATIONAL LEAGUE OF CITIES
NATIONAL ASSOCIATION OF COUNTIES
NATIONAL LEASED HOUSING ASSOCIATION
COUNCIL FOR RURAL HOUSING AND DEVELOPMENT
COUNCIL OF STATE HOUSING AGENCIES
NATIONAL URBAN LEAGUE
U.S. CONFERENCE OF MAYORS

40-276 O—84—11

Exhibit B

BUDGET RECONCILIATION

NET REVENUE EFFECT ON FEDERAL GOVERNMENT
OF ADOPTION OF EXEMPTION FOR EXISTING LOW-INCOME HOUSING
FROM DEFERRED PAYMENT PROVISIONS ADOPTED BY
HOUSE WAYS AND MEANS COMMITTEE AND
SENATE FINANCE COMMITTEE

($ millions)

	FY 1983*	FY 1984*	FY 1985	FY 1986	FY 1987
Syndicated TPA's	(45,000)	(50,000)	(55,000)	(60,000)	(62,500)
Subsidized TPA's	(22,000)	(25,000)	(27,500)	(30,000)	(31,250)
Income Tax Paid (1)(3)		$84.785	$94.205	$103.626	$113.047
Income Tax (Deferred) (2)(3)(4)					
FY 84		(54.710)	(52.000)	(46.405)	(39.881)
FY 85			(60.789)	(57.778)	(51.561)
FY 86				(66.868)	(63.556)
FY 87					(72.947)
Subtotal: Tax Revenue (Loss)		30.075	(18.584)	(67.425)	(114.898)
HUD Assignment-savings generated (5)		75.000	96.250	120.000	144.375
NET FEDERAL REVENUE (LOSS)		$105.075	$77.666	$ 52.575	$ 29.477

(*) The deferred payment provisions adopted by the House and Senate Committees do not apply to sales prior to January 1, 1985. Accordingly, the figures for Fiscal years 1983 and 1984 represent savings of federal revenue which exist under present law and which will not be reduced if these deferred payment provisions are enacted. For later years, the federal revenue gains will only exist if an exemption from these deferred payment rules is adopted.

(1) Assumes average tax rate 36% (including Capital Gain & Recapture).

(2) Assumes 50% taxpayer.

April 6, 1984

(3) Taxes paid (deferred) from FY 83 on 22,500 units, FY 84 on 25,000 units, FY 85 on 27,500 units, FY 86 on 30,000 units, FY 87 on 31,250 units.

(4) Effect from accrual of interest at 10% simple and ACRS 15 year depreciation.

(5) In FY 82, 6,000 units went to assignment at an average $19,200 per unit cost in Federal Revenues. In FY 83, 6,000 units went to assignment at an average $23,300 per unit cost in Federal revenues. HUD estimates that 20% of the subsidized TPA's would have been assigned if "equity refinancing" were not possible. Accordingly, if the proposed legislation adopted by the Ways and Means Committee and the Finance Committee is enacted by Congress, for FY 84, an additional 5,000 units (at a HUD estimated cost of $15,000 per unit) will be assigned which would not have been assigned if present law were retained. Similarly, for FY 85, 5,500 units at $17,500 per unit; for FY 86, 6,000 units at $20,000 per unit; and for FY 87, 6,250 units at $23,100 per unit.

	No. of Units Under Present Law	Federal Cost Under Present Law	Assigned Units Under Proposed Legislation	Total Federal Cost Under Proposed Legislation	Net Increase in Federal Costs Under Proposed Legislation
FY 82	6,000	$115,200,000	6,000	$115,200,000	$
FY 83	6,000	140,000,000	6,000	140,000,000	
FY 84 (p)	2,500	37,500,000	7,500	37,500,000	
FY 85 (p)	3,000	52,500,000	8,500	148,750,000	96,250,000
FY 86 (p)	4,000	80,000,000	10,000	200,000,000	120,000,000
FY 87 (p)	5,200	120,120,000	11,450	264,495,000	144,375,000
Total		$545,320,000		$980,945,000	$435,625,000

(p) HUD projections based upon assumption that the present level of additional appropriations for flexible subsidies and loan management set aside funds continues.

(6) Not reflected on the chart are other items such as additional capital improvement needs and delinquencies. For example, HUD estimates that 50% of the subsidized TPA's where equity is refinanced under present tax laws contribute $1,000 per unit to capital improvements. Therefore, under present tax law, for FY 85, 13,750 units at $1,000 per unit in Federal revenues would be saved, i.e., $13,750,000. Similarly, for FY 86 15,000 units ($15,000,000); and for FY 87, 15,625 units ($15,625,000).

OFFICIAL FILE COPY

Exhibit B

United States Senate

SUBCOMMITTEE ON HOUSING
AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

DA 84-3100

April 4, 1984

Hon. Samuel Pierce
Secretary
Department of Housing and Urban Development
Washington, D.C.

Dear Mr. Secretary:

I am troubled by reports that housing for low and moderate income people would be adversely affected by a provision in the Senate-reported "Deficit Reduction Package" that would change the original issue discount rules. I feel strongly that short-term considerations must not be permitted either to jeopardize the nation's enormous investment in decent, low-income housing or to increase long-term costs to the taxpayers.

So that the Senate can understand the full budgetary impact of this provision, I request that the Department of Housing and Urban Development describe how the proposed change in law could reduce private investment to maintain the habitability of existing, HUD-assisted low income rental housing.

I also request the Department's estimate of how this change in law could reasonably be expected to affect future FHA Insurance Fund obligations.

The Coalition for Low and Moderate Income Housing has provided the attached table, which shows that exempting existing low-income housing from the OID rule change could actually reduce the Federal deficit by generating HUD assignment savings that are larger than the projected tax revenue loss. Does this exhibit reflect the Department's estimate of the fiscal effects of exempting HUD-assisted housing from the OID rule change?

Since Senate floor action is expected early next week, I will need your response in writing very soon.

Thank you very much.

Sincerely,

Donald W. Riegle, Jr.
U.S.S.

Exhibit B

BUDGET RECONCILIATION

NET REVENUE EFFECT ON FEDERAL GOVERNMENT
OF ADOPTION OF EXEMPTION FOR EXISTING LOW-INCOME HOUSING
FROM DEFERRED PAYMENT PROVISIONS ADOPTED BY
HOUSE WAYS AND MEANS COMMITTEE AND
SENATE FINANCE COMMITTEE

($ millions)

	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987
Syndicated TPA's	(45,000)	(50,000)	(55,000)	(60,000)	(62,500)
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ubtotal: Tax Revenue (Loss)		30,075	(18,584)	(67,425)	(114,898)
HUD Assignment-savings generated (5)		75,000	96,250	120,000	144,375
NET FEDERAL REVENUE (LOSS)		$105,075	$77,666	$ 52,575	$ 29,477

(1) Assumes average tax rate 36% (including Capital Gain & Recapture).

(2) Assumes 50% taxpayer.

(3) Taxes paid (deferred) from FY 83 on 22,500 units, FY 84 on 25,000 units, FY 85 on 27,500 units, FY 86 on 30,000 units, FY 87 on 31,250 units.

(4) Effect from accrual of interest at 10% simple and ACRS 15 year depreciation.

(5) In FY 82, 6,000 units went to assignment at an average $19,200 per unit cost in Federal revenues. In FY 83, 6,000 units went to assignment at an average $23,300 per unit cost in Federal revenues. HUD estimates that 20% of the subsidized TPA's would have been assigned if "equity refinancing" were not possible. Accordingly, if the proposed legislation adopted by the Ways and Means Committee and the Finance Committee is enacted by Congress, for FY 84, an additional 5,000 units (at a HUD estimated cost of $15,000 per unit) will be assigned which would not have been assigned if present law were retained. Similarly, for FY 85, 5,500 units at $17,500 per unit; for FY 86, 6,000 units at $20,000 per unit; and for FY 87, 6,250 units at $23,100 per unit.

	No. of Units Under Present Law	Federal Cost Under Present Law	Assigned Units Under Proposed Legislation	Total Federal Cost Under Proposed Legislation	Net Increase in Federal Costs Under Proposed Legislation
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FY 85 (p)	3,000	52,500,000	8,500	148,750,000	96,250,000
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Total		$545,320,000		$980,945,000	$435,625,000

(p) HUD projections based upon assumption that the present level of additional appropriations for flexible subsidies and loan management set aside funds continues.

(6) Not reflected on the chart are other items such as additional capital improvement needs and delinquencies. For example, HUD estimates that 50% of the subsidized TPA's where equity is refinanced under present tax laws contribute $1,000 per unit to capital improvements. Therefore, under present tax law, for FY 84, 12,500 units at $1,000 per unit in Federal revenues would be saved, i.e., $12,500,000. Similarly, for FY 85, 13,750 units ($13,750,000); for FY 86 15,000 units ($15,000,000); and for FY 87, 15,625 units ($15,625,000).

Exhibit C

THE SECRETARY OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

May 22, 1984

Honorable Donald W. Riegle, Jr.
Subcommittee on Housing and Urban
Affairs
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Riegle:

Thank you for your letter of April 4, 1984, regarding the potential impact of the so-called "OID provision" of the pending tax legislation which, at that time, had been reported by the Finance Committee and was awaiting floor action. You asked for our comment on how this proposed change could (1) reduce private investment to maintain the habitability of existing, HUD-assisted low income rental housing, and (2) affect future FHA Insurance Fund obligations. In addition, you asked whether a "Net revenue effect" table prepared by the Coalition for Low and Moderate Income Housing reflected the Department's estimate of the fiscal effects of exempting HUD-assisted housing from the proposed tax amendment.

Subsequently, the Senate agreed to the "Deficit Reduction Tax Act of 1984" offered by Senator Dole after tabling the amendment offered by you, Mr. Cranston, and others which would have exempted certain HUD-assisted and other low-income rental housing from the "OID provision," which comprises Section 74 of the Act. Because the deficit reduction package passed by the House contains a similar provision, I am assuming that the "OID provision" will be enacted. We have, therefore, begun to assess the potential impact of this change within the context of a larger effort to analyze the condition and needs of the inventory of subsidized low-income rental projects with HUD-insured or HUD-held mortgages, plus projects owned by HUD.

There is a substantial inventory of low-income rental projects with FHA-insured or Secretary-held mortgages with pre-Section 8, relatively shallow subsidies. The major portion of this inventory consists of approximately 440,000 units insured under Section 236 and approximately 154,000 units insured under Section 221(d)(3) with below-market interest rates (BMIR). Few of these projects are able to generate cash from operations that is sufficient to maintain full reserves, much less fund capital improvements. Many fall into default on debt service, resulting in assignment of mortgages to HUD (and consequent immediate payment of insurance claims). The tax benefits available from resyndication -- or, in our terminology, transfers of physical

assets (TPA's) -- have provided a means of obtaining cash contributions from new owners necessary to cure delinquencies, fund reserves and deferred maintenance, and even fund repairs and replacements chargeable to capital account (boiler, roofs, etc.).

Encouragement of TPA's as a vehicle for obtaining capital infusion for low-income rental projects began several years before enactment of the Economic Recovery Tax Act of 1981. At that time, however, the activity was limited to transfers by nonprofit owners to tax-motivated limited dividend owners. The increased tax benefits for acquisition of existing properties which were made available by ERTA, plus the availability of interest deductions arising from seller secondary financing on which actual payments were deferred, made it possible to raise an additional amount of cash in a TPA transaction sufficient to cover a taxpaying seller's tax liability arising from the transfer, which made it feasible to extend the process to transfers by existing limited dividend owners to new limited dividend owners.

It is clear to me that the interests of the Department have benefited from many of the resyndications of subsidized limited dividend projects which have occurred since enactment of the Economic Recovery Tax Act of 1981. Re-commencement of the tax incentives created for low-income rental housing at a point in time when those benefits have largely spent themselves provides an occasion for an infusion of necessary capital into a project. It is also clear that the tax losses attributable to accrued interest on secondary seller financing have been a major factor in permitting extension of the resyndication process to existing limited dividend projects. Information normally available to us does not permit an analysis of the tax impacts of TPA's on either sellers or buyers, so we do not have an independent data base on this point. However, we have examined a representative sampling of offering statements and other data relating to actual transactions, and the information disclosed is confirmatory of the impression gained by our staff from participation in negotiations. We are satisfied that interest deductions attributable to secondary financing account for losses that are in the order of 20 percent to 35 percent of the tax losses realized during the first five years after resyndication. Put another way, the absence of these deductions would reduce the ratio of loss to investment during that period, in what would appear to be representative cases, from approximately 2:1 (the amount necessary to provide recovery of investment by a 50 percent bracket taxpayer during that period) to approximately 1.6:1. Under current market conditions at least, we understand that the latter ratio would not be considered marketable in the case of a low-income project. Accordingly, as transactions have been structured during the past several years, the accrued interest deductions have been critical to feasibility of the transaction in a substantial number of cases.

I hasten to add that I do not believe that the current deductibility of deferred interest, with the concurrent non-recognition of income by a cash-basis seller-payee, is an efficient or desirable means of subsidizing these transactions. It is difficult to avoid agreement with the Treasury's view that this constitutes an accounting abuse. Further, it is particularly inefficient from a housing policy perspective, in that it makes no distinction between buyer contributions which aid the project and contributions which aid only the seller or syndicators. As I've indicated, the principal factor leading to the extension of the resyndication process from solely nonprofit owners to limited dividend owners was the new ability to raise enough cash to cover the sellers' tax liabilities. Studies made available to us indicate that well over half of the cash raised in transactions typically is devoted to this purpose, and the portion of the cash raised which is devoted to property needs is only about 20 percent or less. On the basis of this data, it is difficult to assess the net benefits derived from extension of the process to this class of sellers. Of course, many subsidized projects which are resyndicated because of the benefits of current law need not be considered candidates for assignment in the absence of resyndication. In these cases, I cannot say that the benefits of resyndication outweigh either the tax revenue losses that result or the defects in the rules that create the losses.

I also cannot estimate with any certainty how many transactions which might have occurred under current law will not occur because of enactment of the OID provision. Any such estimate would have to take into account the availability of other devices to achieve comparable tax results, the impacts of other tax changes on competing investments, and the willingness of sellers to accept a pricing change necessitated by law changes. Largely for this reason, I am unable to affirm the estimates of tax revenues and losses provided by the Coalition.

An estimate of how many transactions occurring under current law will not occur because of the change of law is critical to both the "Income tax paid by sellers" line and the "Income tax (Deferred by new buyers)" lines of the table. (For convenience, I am referring to the version of the table which was reproduced in the Congressional Record at page S 4258 (April 10, 1984).)As I understand the intent of this portion of the table, the "Income tax paid" line should indicate sellers' tax payments for only those resyndication transactions which will not occur without an exemption. The table appears to be based on an assumption that all subsidized project resyndications occurring under current law will be halted by the change in law (see footnote 3). As indicated above, I am not prepared to confirm this assumption, so it appears likely that the estimated revenues included in the "Income tax paid" line are overstated.

At the same time, the tax deferrals indicated in the lines following are also likely to have been overstated. The deferrals

shown in the table include all reductions in tax revenues arising from both deferred interest payments and 15-year ACRS depreciation. I believe, however, that the only pertinent deferrals would be (i) all revenue reduction arising from transactions which would not occur without the exemption, plus (ii) additional revenue reduction attributable to deferred interest payments from transactions which would occur without the exemption. In other words, the pertinent revenue reduction should not include tax deferrals attributable to depreciation for the transactions which will occur without the exemption.

Accordingly, our best guess is that both the "Income tax paid" and the "Income tax (deferred)" lines of the table are overstated. As a result, I am unable to provide an estimated subtotal for annual "Tax revenue gain (loss)." Of course, it is evident that the revenue reduction arising from transactions occurring in the years shown in the table will continue for a number of years past those shown.

I would like to be in a better position to give detailed and definitive analysis of the "Savings generated for HUD assignment program" line of the table. Regrettably, we are not fully able to do so. As noted above, transfers of limited dividend owner projects only began to be an extensive activity in FY 1982, after enactment of ERTA. We only began to keep record of the number of such transactions which were occurring in mid-FY 1983. We have not yet aggregated and analyzed this limited experience to inform ourselves of its results in terms of capital infusions achieved for projects, amounts of debt service and reserve fund arrearages collected, deferred maintenance and repairs funded, and so forth. Also, information necessary for estimating tax impacts of transactions on sellers and buyers normally is not available to us. The unavailability of this data is critical to our inability to estimate with any precision the expected impact of the change of tax law in terms of number of transactions which will not occur or differences in terms of transactions which will continue to occur.

Subject to the foregoing limitations, I offer the following comments on various elements included in the "Savings generated" data presented by the Coalition. It is true that these estimates were developed by the Coalition following consultation with HUD staff.

The number of units covered by syndicated TPA's in FY 1983 for all insured projects and for subsidized projects only (shown in the first lines of the table) represent annualization of half-year figures. As indicated above, we began to keep track of this activity in mid-1983. The FY 1984 amounts, similarly, are annualizations of activity through the first six months. We have no basis for confirming or questioning the validity of the estimates of activity level projected for future years.

HUD received 69 multifamily assignment claims in FY 1982 and

60 claims in FY 1983. (These represented declines from 84 in FY 1979, 79 in FY 1980, and 92 in FY 1981. The decline is attributable in part to the decline in prevailing interest rates, reducing a lender's incentive to assign, and, to a degree not calculable, to anticipation of potential resyndication following enactment of ERTA.)

When discussing this data with the Coalition, we estimated that the average number of dwelling units covered by each assignment claim was 100. The actual number of units covered by assigned mortgages were 7,082 in FY 1982, 5,749 in FY 1983.

The "Federal Cost Under Present Law" amounts for FY 1982 and FY 1983 shown in note 5 represent unpaid principal balances of mortgages received for assignment in those years. There are, of course, other assignment costs, particularly post-acquisition holding costs, which are offset by an eventual 30 percent (average) recovery on disposition of the property after foreclosure and acquisition of title. Without further detailed calculation, we consider that utilizing unpaid mortgage amounts provides useful rough estimates of actual assignment costs. Based on the unit figures stated above, the per-unit costs in FY 1982 were $16,355 and in FY 1983 were $24,300. (The FY 1983 per-unit amount was impacted heavily by a single large project which included much commercial space, distorting the amount when divided by residential units only.)

The estimate that 2,500 units will be assigned to HUD in FY 1984 represents an annualization of the experience of the first six months. The projected annual cost for this year (based on unpaid mortgage amount, as discussed above) is $16,062. The decline in assignments in FY 1984 from FY 1983 is attributable to a number of factors, including further decline in interest rates early in the fiscal year, a tougher HUD posture in moving projects quickly from assignment to foreclosure (with a resulting less casual attitude on the part of borrowers toward defaults that trigger assignments), and availability of Section 8 loan management set-aside funds in FY 1983.

In discussions with Coalition representatives, HUD staff provided an estimate that, in the absence of resyndications, HUD would incur assignment costs for an additional number of units approximately equal to 20 percent of the subsidized units currently being resyndicated. Given the absence of analyzed data regarding our limited experience to which I referred above, this estimate was extremely rough. (For instance, it did not take into account the number of units covered by syndicated TPA's in FY 1983 in projects whose mortgages had already been assigned to HUD.) Nevertheless, we still have no better one to offer, and I do not wish to imply that this assumption, which is key to the projections offered by the Coalition, is necessarily invalid. I must caution, however, that the estimate was made against a background of current activity levels, so that it does not necessarily follow that the amount of units assigned would

necessarily follow that the amount of units assigned would increase progressively in future years. In fact, the rate of assignments in the absence of resyndication is likely to be influenced more directly by the levels of available loan management set-aside and flexible subsidy assistance than by the level of resyndication activity. In addition, the estimate was not intended to imply that the assignments would be likely to occur in the same year that, under current law, a resyndication might have occurred. In fact, an assignment would more likely occur several years later in most cases. Also, as the figures shown above indicate, there is little historic basis for an assumption that per-unit costs also will increase.

For the reasons stated above, therefore, we are not able to quantify with an acceptable degree of comfort the likely impact of the tax law change on the HUD-insured inventory. Nevertheless, it is clear that some transactions will be hindered and, more pertinently, that it is the transactions most likely to be able to advance housing objectives that are the most likely to be halted. The reason is obvious: any incremental reduction of available tax benefits will reduce the amount of cash that can be raised to meet project needs in addition to the private demands of sellers. Therefore, the transactions which would contribute the most toward project needs are precisely the transactions most likely to be halted by the tax change.

We recognize this result and are determined to face up to it. The inventory of existing assisted multifamily housing represents an important Government investment. Management of that investment has been and will continue to be one of the most challenging tasks of the Department. As suggested above, I do not believe that any adverse impacts of the tax law change will be immediate. There should, therefore, be sufficient time to consider more rational and efficient alternatives before the matter reaches crisis proportions. Assistant Secretary Barksdale has commenced a concentrated program to develop a comprehensive profile of the current condition and projected needs of the inventory as well as an evaluation of the effectiveness and efficiency of different tools for its preservation, including flexible subsidy, loan management rental subsidies, tax incentives, and possible additional means. I want to assure you that I regard our responsibility and our accountability to the Congress in this respect as a serious and pressing matter, to which we must respond intelligently and forthrightly.

Very sincerely yours,

Samuel R. Pierce, Jr.

Exhibit D

Copy of Amendment No. 3004 to the
Deficit Reduction Act of 1984,
Which Amendment was Offered on April 12, 1984,
by Senator Cranston and Others, and
Tabled by the Senate

At the appropriate place, Page 133, after line 14 add

(j) SPECIAL RULE IN THE CASE OF LOW-INCOME HOUSING.

(1) IN GENERAL. -- Section 1274 of the Internal Revenue Code of 1954 (relating to treatment of bonds and other debt instruments as added by this subtitle) shall not apply to any qualified indebtedness of the taxpayer.

(2) QUALIFIED INDEBTEDNESS DEFINED. -- For purpose of this subsection, the term "qualified indebtedness" means any indebtedness of the taxpayer owed to the transferor (or a related person) which is incurred in connection with the transfer to such taxpayer of low income housing or, in the aggregate, 90% or more of the capital interest, or the profits interest, of a partnership owning low-income housing where the indebtedness and interest thereon meet the requirements contained in paragraph (3) and the transfer of the low-income housing or such partnership interest meets the following requirements:

(A) The United States Department of Housing and Urban Development, the United States Farmers Home Administration, or a State or local housing authority has approved the transfer pursuant to laws, regulations or procedures governing the transfer of physical assets.

(B) Within 24 months after such transfer, (i) the new owner of the low income housing has made all improvements and met all financial requirements called for by the United States Department of Housing and Urban Development, the United States Farmers Home Administration, or the State or local agency as a condition of such approval, and (ii) the low income housing meets the housing quality standards prescribed by the Department of Housing and Urban Development for existing housing under section 8 of the United States Housing Act of 1937.

(C) The low-income housing or such partnership interests have been owned by the transferor for at least twelve months, or were acquired by the taxpayer pursuant to a purchase, assignment or other transfer from the United

States Department of Housing and Urban Development, the United States Farmers Home Administration or any State or local housing authority.

(3) OTHER REQUIREMENTS. -- Interest on qualified indebtedness shall not be deductible to the extent that -- if

(A) Such interest exceeds two percentage points above the annual rate established under section 6621 (interest on underpayments of tax) at the time of the transfer;

(B) Such interest accrues for a period of longer than fifteen years and six months;

(C) The interest on which is not exempt from Federal income tax; and

(D) The indebtedness is not wraparound indebtedness.

(4) RECAPTURE OF INTEREST DEDUCTION. -- If, at the end of the period described in paragraphs (2)(B), all or any portion of the accrued interest on the qualified indebtedness is not paid by the taxpayer, then gain shall be recognized to the taxpayer to the extent of the lower of --

(A) the amount of all prior interest deductions taken on such qualified indebtedness, or

(B) the amount of such accrued interest which is not paid by the taxpayer.

Such gain shall be treated as ordinary income.

(5) DEFINITION OF LOW-INCOME HOUSING. -- For purposes of this subsection, low-income housing means property described in clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B) and which is subject to the restrictions described in section 1039(b)(i)(B).

(6) PERIOD OF APPLICABILITY. -- The provisions of this subsection shall apply only to qualified indebtedness which is -- (i) incurred on or before December 31, 1985, or (ii) incurred pursuant to a contract which was binding on December 31, 1985, and at all times thereafter, and the transfer occurs before July 1, 1986.

August 9, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Gentlemen:

I wish this letter to be included in the printed record of the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

The changes made to the "imputed interest rules" of Section 483 by the enactment of Section 1274, at least in the area of the sale of real property, has created a wholly unnecessary and unmanageable complicity to an area of the tax law that was already too complicated to be understood by any taxpayer other than CPA's. In my experience, the average attorney, let alone the average taxpayer, could not understand the present value discounting rules of Section 483. Now you have added a further complication that will certainly eliminate almost all of the Internal Revenue Service Agents from being able to understand and audit compliance with the law. Section 1274 is TOO COMPLICATED to be understood by all except mathematicians and CPA's.

In real estate transactions, I would suggest there will be little compliance with the law unless both the purchaser and the seller have CPA's prepare their income tax returns. Furthermore, the IRS will not be able to monitor compliance because the vast majority of Internal Revenue Agents will not be able to understand the "present value computations" of Section 1274.

To tie the interest rates on a seller carryback of real property to 120% of the interest rate charged on federal treasury instruments, thereby making the interest rate greater than that charged by commercial lenders, fails to recognize several significant economic differences between sellers of real property who "carryback" financing on the one hand and commercial lenders on the other hand.

(1) The commercial lender has a fully operating business staffed by several employees and involving a significant capital investment. The commercial lender has to charge two to three interest points above its cost of money to cover its cost of doing business, a return on its capital and a profit amount. The individual seller does not have such costs and in most real property transactions the seller of real property will carryback financing two to three

interest points below commercial market rates because he has no cost of doing business.

(2) Secondly, the interest rate that a seller receives on a carryback is generally equivalent to what such seller would receive from an investment in a fixed income investment, such as treasury notes, corporate bonds and bank savings accounts. Today a commercial lender on a loan secured by real property is commanding a 13-3/4% to 14% rate. The current interest rate being paid on money market accounts is about 10-1/2%. On the other hand, 120% of the current short-term T-Note yield would be approximately 14.7%. Under Section 1274 the law requires the seller to report an interest income forty percent greater than what such seller would receive from available alternative investments.

(3) When the seller carrys back financing, the debt instrument owned by the seller is secured by a lien on the property sold. In almost all cases the seller has "first rate security" for the payment of his loan. The greater the security the lower the interest rate should be. On the other hand, if a person is willing to risk his capital, such as in the purchase of a corporate bond, then the interest rate should be higher. The upper interest rate level under Section 1274 should be equal to the treasury note yields, not 120% of such yields.

In enacting Section 1274 the economics of real property transactions were not adequately understood. In many real estate transactions the time period between the parties entering into an Agreement for Sale and the actual closing of the transaction (i.e. the transfer of title and payment) can be many months to even years. For example, in a raw land transaction the closing may be contingent upon rezoning or platting and because of the governmental process, may be upwards of two years time span between the contract date and the closing date. Frequently, in a lease transaction, the lessee may be granted the option to purchase the property five or ten years later. All of the terms of the Purchase Agreement must be provided for in the lease/option agreement. In most real property transactions, the time difference between contractual agreement and closing is from 60 days to 180 days. In all of the above examples, because of the time lag, a contract could be entered into complying with the complicated rules of Section 1274 and prior to closing, the interest rates could change causing the transaction at closing to no longer comply with Section 1274. Congress has created an intolerable situation for real property transactions in that people who are entering into contractual agreements will have no way of determining the tax consequences of such transactions at the time of signing such Real Property Purchase and Sale Agreements. One of the very basic tenants of tax law has been that it should be clear, understandable, and taxpayers should be able to measure the tax consequence of their acts at the

time they are entering into agreements. This can not be accomplished in a real estate transaction under Section 1274.

Under the old rules of Section 483, a taxpayer could calculate the tax consequences of his acts. Under the new Section 1274, very few taxpayers, and even fewer IRS agents, would be able to calculate the tax results of a transaction. Furthermore, a reasonable rate of interest should be the measuring device, not a rate of interest that is in excess of a rate of interest charged by the most expensive of commercial real property lenders.

To force the parties to a real estate transaction to charge a rate of interest greater than treasury rates or commercial lending rates is a highly inflationary measure. Such a law is counterproductive to Congress' intent to reduce inflation. Its primary impact will be to increase the cost of living and commercial properties. What this country doesn't need is high priced housing.

If Section 1274 cannot be repealed, then the testing rate should be reduced to 80% of an appropriate treasury note yield and the top rate should be equal to the appropriate treasury note yield. Furthermore, the rate should be the applicable rate at the date the contract is entered into, not the date of closing of the real estate transaction.

To change the rates would not have any appreciable effect on government revenues. Under Sections 483 and 1274, to the extent the seller's interest income is increased, the buyer's interest deduction is also increased resulting in offsetting each other. In other words, for each dollar of additional interest income there would be a matching dollar of interest deduction.

Very truly yours,

Gordon W. Fatherton

cc: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart

F Aug 3

WILLIAM H. FERNHOLZ
ATTORNEY AT LAW
5730 NORTH KENT AVENUE
MILWAUKEE, WISCONSIN 53217

August 10, 1984

Mr. Roderick DeArment, Chief Counsel
Committee on Finance
United States Senate
Room SD 219
Washington, DC 20510

Dear Mr. DeArment:

Our daughter is a resident of Southern Wisconsin Center for the Developmentally Disabled. She is profoundly retarded and subject to behavior disorders which can best be handled in an institutional setting where medical, psychological and nursing services are readily available. The institution, in a lovely bucolic setting, is clean, cheerful and well-staffed - a situation which has done much to relieve our sorrow.

Under these circumstances, we are understandably alarmed by the prospect of S.2053, Community and Family Living Amendments of 1983.

Certainly most retarded people can benefit from community facilities. Just as certainly, some cannot, and in those cases, even the most dedicated social technician must fall back on ordinary common sense. Our daughter and most of her fellow residents operate at levels below those of normal two year old children. In a community setting, they would be at risk every time they stepped outdoors unattended, to say nothing of the possibilities for abuse within a poorly supervised group home. The effects of this ill-conceived legislation would be tragic for this most vulnerable group of the retarded population, and we strongly oppose the closing of well-run institutions such as those in Wisconsin.

We might point out that the Association for Retarded Citizens, which does support S.2053, does not speak for a unanimous membership. We have been assured by our local chapter that they fought hard - and continue to fight - against the measure which passed by a narrow margin at the national level.

The proposed law is a classic case of well-intended aims gone awry. We beg that humane and reasonable standards be applied to assure that those most in need of a highly protected and well supervised setting are able to retain it.

Sincerely,

William and Barbara Fernholz

40-276 O—84——12

JOHN M. FAHRENKROG

August 13, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SC-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

Please include this letter in the printed record of the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

The changes made to the "imputed interest rules" of Section 483 by the enactment of Section 1274, at least in the area of the sale of real property, has created a unmanageable complicity by any area of the tax law that is already too complicated to be understood by any taxpayer. In my opinion, the average attorney, let alone the average taxpayer, could not understand the present value discounting rules of Section 483. Now you have added a further complication that will certainly eliminate almost all of the Internal Revenue Service Agents from being able to understand and audit compliance with the law. Section 1274 is TOO COMPLICATED to be understood by all except mathematicians and CPA's.

In real estate transactions, I would suggest there will be little compliance with the law unless both the purchaser and the seller have CPA's prepare their income tax returns. Furthermore, the IRS will not be able to monitor compliance because the vast majority of Internal Revenue Agents will not be able to understand the "present value computations" of Section 1274.

To tie the interest rates on a seller carryback of real property to 120% of the interest rate charged on federal treasury instruments, thereby making the interest rate greater than that charged by commercial lenders, fails to recognize several significant economic differences between sellers of real property who "carryback" financing on the one hand and commercial lenders on the other hand.

(1) The commercial lender has a fully operating business staffed by several employees and involving a significant capital investment. The commercial lender has to charge two to three interest points above its cost of money to cover its cost of doing business, a return on its capital and a profit amount. The individual seller does not have

BOX 2 DENVER, COLORADO 80201

such costs and in most real property transactions the seller of real property will carryback financing two to three interest points below commercial market rates because he has no cost of doing business.

(2) The interest rate that a seller receives on a carryback is generally equivalent to what such seller would receive from an investment in a fixed income investment, such as treasury notes, corporate bonds and bank savings accounts. Today a commercial lender on a loan secured by real property is commanding a 13-3/4% to 14% rate. The current interest rate being paid on money market accounts is about 10½%. On the other hand, 120% of the current short-term T-Note yield would be approximately 14.7%. Under Section 1274 the law requires the seller to report an interest income forty percent greater than what such seller would receive from available alternative investments.

(3) When the seller carrys back financing, the debt instrument owned by the seller is secured by a lien on the property sold. In almost all cases the seller has "first rate security" for the payment of his loan. The greater the security the lower the interest rate should be. On the other hand, if a person is willing to risk his capital, such as in the purchase of a corporate bond, then the interest rate should be higher. The upper interest rate level under Section 1274 should be equal to the treasury note yields, not 120% of such yields!

In enacting Section 1274 the economics of real property transactions were not adequately understood. In many real estate transactions the time period between the parties entering into an Agreement for Sale and the actual closing of the transaction (i.e. the transfer of title and payment) can be several months to several years. For example, in a raw land transaction the closing may be contingent upon rezoning or platting and because of the governmental process, may be upwards of two years time span between the contract date and the closing date. Frequently, in a lease transaction, the lessee may be granted the option to purchase the property five or ten years later. All of the terms of the Purchase Agreement must be provided for in the lease/option agreement. In most real property transactions, the time difference between contractual agreement and closing is from 60 days to 180 days. In all of the above examples, because of the time lag, a contract could be entered into complying with the complicated rules of Section 1274 and prior to closing, the interest rates could change causing the transaction at closing to no longer comply with Section 1274. Congress has created an intolerable situation for real property transactions in that people who are entering into

contractual agreements will have no way of determining the tax consequences of such transactions at the time of signing such Real Property Purchase and Sale Agreements. One of the very basic tenants of tax law has been that it should be clear, understandable, and taxpayers should be able to measure the tax consequence of their acts at the time they are entering into agreements. This cannot be accomplished in a real estate transaction under Section 1274.

Under the old rules of Section 483, a taxpayer could calculate the tax consequences of his acts. Under the new Section 1274, no one will be able to calculate the tax results of a transaction until after the closing. Furthermore, a reasonable rate of interest should be the measuring device, not a rate of interest that is in excess of a rate of interest charged by the most expensive of commercial real property lenders.

To force the parties to a real estate transaction to charge a rate of interest greater than treausry rates or commercial lending rates is a highly inflationary measure. Such a law is conterproductive to Congress' intent to reduce inflation.

If Section 1274 cannot be repealed, then the testing rate should be reduced to 80% of an appropriate treasury note yield and the top rate should be equal to the appropriate treasury note yield. Furthermore, the rate should be the applicable rate at the date the contract is entered into, not the date of closing of the real estate transaction.

To change the rates would not have any appreciable effect on government revenues. Under Sections 483 and 1274, to the extent the seller's interest income is increased, the buyer's interest deduction is also increased resulting in offsetting each other. In other words, for each dollar of additional interest income there would be a matching dollar of interest deduction.

Sincerely,

John M. Fahrenkrog

BOX 2 DENVER, COLORADO 80201

RONALD BUD FIGEL
2735 East 7th Avenue, Denver, Colorado 80206

August 15, 1984

Robert A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D. C. 20510

Gentlemen:

The purpose of this letter is to personally protest provisions relating to the imputed interest rules of Code Section 483 and the New Code Section 1274. I request that this protest be included in the printed record of hearing. The following are a few of my concerns:

(1) The provisions serve no beneficial purpose to increasing the federal revenues. Forcing higher interest rates in order to generate higher "ordinary income" to the lender is offset by the borrower taking that same deduction of ordinary income.

(2) Forcing higher interest rates is inflationary by its nature.

(3) The fixing of interest rates is against all Federal Trade Commission pursuits and objectives.

(4) Land sales, particularly, are not feasible without favorable seller carryback terms. Please keep in mind, there is no "income" and only "outgo".

(5) Commercial lenders do not normally lend on unimproved land.

(6) The cost to the seller who carries back a loan is substantially less than the cost to a commercial lender who has normal business overhead and expense. The seller's interest rate should therefore be less than a commercial lender's rate.

The above statements are admittedly very general, but I believe

you will appreciate the rationale of my objections.

Your input and influence to at least modify those changes to the imputed interest rules of Code Section 483 and the New Code Section 1274 is imperative.

Very truly yours,

Ronald Figel

Ronald Figel, S.I.R.

cc: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart

JOHN E. FULLER, JR.
5354 South Hoyt Street
Littleton, CO 80123

August 16, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

I am very concerned with recent legislation regarding the "imputed interest rules," and I wish this letter to be included in the printed record of the hearing on the changes to the "imputed interest rules" of Code Section 483 and New Code Section 1274.

There are many changes made to the "imputed interest rules" of Section 483 by the enactment of Section 1274 that I am dissatisfied with, but I am mainly concerned with the changes regarding the sale of real property. It is my understanding that one of the very basic rules of tax law is that it should be very clear, very understandable, and the taxpayer should be able to measure his tax consequences regarding his transaction at the time he enters into the agreement. With the new changes in the "imputed interest rule," an owner selling his property does not know his tax consequences at the time he enters into the agreement. For example, many real estate transactions, from the time entering into the agreement to sell the real estate to the time of the actual closing, might take as long as one year or longer. When the seller enters into the agreement to sell his property and offers owner-carry financing at a certain interest rate, he should at that point know his tax consequences. But, if his transaction takes a year or longer to close, this is not the case and he does not know what interest rate he will be charging on his owner-carryback financing. I feel that this violates one of the very basic tenets of tax law and also what we believe in America, which is the free enterprise system.

Very truly yours,

John E. Fuller, Jr.

cc: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart

Warren A. Moreau
Director
Planning and Investment Services

August 13, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

I wish this letter to be included in the printed record of the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

The "imputed interest rules" changes of Section 483 by the enactment of Section 1274, as they pertain to the sale of real property, has created a wholly unnecessary and unmanageable complicity to an area of the tax law that was already too complicated to be understood by any taxpayer other than CPA's.

My bases for objection to the rule changes are as follows:

(1) To tie the interest rates on a seller carryback of real property to 120% of the interest rate charged on federal treasury instruments, thereby making the interest rate greater than that charged by commercial lenders, fails to recognize several significant economic differences between sellers of real property who "carryback" financing on the one hand and commercial lenders on the other hand.

(2) The commercial lender has a fully operating business staffed by several employees and involving a significant capital investment. The commercial lender has to charge two to three interest points above its cost of money to cover its cost of doing business, a return on its capital and a profit amount. The individual seller does not have such costs and in most real property transactions the seller of real property will carryback financing two to three interest points below commercial market rates because he has no cost of doing business.

One Park Central 1515 Arapahoe Street Denver, Colorado 80202 303-292-3700

(3) Secondly, the interest rate that a seller receives on a carryback is generally equivalent to what such seller would receive from an investment in a fixed income investment, such as treasury notes, corporate bonds and bank savings accounts. Today a commercial lender on a loan secured by real property is commanding a 13-3/4% to 14% rate. The current interest rate being paid on money market accounts is about 10-1/2%. On the other hand, 120% of the current short-term T-Note yield would be approximately 14.7%. Under Section 1274 the law requires the seller to report an interest income forty percent greater than what such seller would receive from available alternative investments.

(4) When the seller carrys back financing, the debt instrument owned by the seller is secured by a lien on the property sold. In almost all cases the seller has "first rate security" for the payment of his loan. The greater the security the lower the payment of his loan. The greater the security the lower the interest rate should be. On the other hand, if a person is willing to risk his capital, such as in the purchase of a corporate bond, then the interest rate should be higher. The upper interest rate level under Section 1274 should be <u>equal</u> to the treasury note yields, not 120% of such yields.

(5) In many real estate transactions the time period between the parties entering into an Agreement for Sale and the actual closing of the transaction (i.e. the transfer of title and payment) can be many months to even years. For example, in a raw land transaction the closing may be contingent upon rezoning or platting and because of the governmental process, may be upwards of two years time span between the contract date and the closing date. Frequently, in a lease transaction, the lessee may be granted the option to purchase the property five or ten years later. All of the terms of the Purchase Agreement must be provided for in the lease/option agreement. In most real property transactions, the time difference between contractual agreement and closing is from 60 days to 180 days. In all of the above examples, because of the time lag, a contract could be entered into complying with the complicated rules of Section 1274 and prior to closing, the interest rates could change causing the transaction at closing to no longer comply with Section 1274. Congress has created an intolerable situation for real property transactions in that people who are entering

into contractual agreements will have no way of determining the tax consequences of such transactions at the time of signing such Real Property Purchase and Sale Agreements.

(6) One of the very basic tenants of tax law has been that it should be clear, understandable, and taxpayers should be able to measure the tax consequence of their acts at the time they are entering into agreements. This can not be accomplished in a real estate transactions under Section 1274.

In order to provide for a more reasonable approach, if Section 1274 cannot be repealed, I suggest that the testing rate be reduced to 80% of an appropriate treasury note yield and the top rate should be equal to the appropriate treasury note yield. Also, the rate should be the applicable rate at the date the contract is entered into, not the date of closing of the real estate transaction.

Thank you for your consideration to this matter.

Very truly yours,

Warren A. Moreau

dcs

cc: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart

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JAMES BLYTHE HODGE
PETER S. BUCHANAN
WILLIAM A. FALIK*
STANLEY M. DUPREE
RICHARD A. LELAND, JR.
WADE H. HUFFORD
JOHN G. MACRIE

*A PROFESSIONAL CORPORATION

OF COUNSEL
JOAN M. McGUIRE

August 8, 1984

Honorable Robert Packwood
259 Russell
Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

I am a practicing tax attorney who is acutely aware of the need for our country to raise additional revenue through closing tax loop holes. I applauded many of your efforts in championing the Deficit Reduction Act of 1984 and particularly the tax reform provisions thereof. However, the imputed interest changes and the OID rules in my opinion represent a distortion of economic reality and will create immense problems for the real estate community. My personal feeling is that the only segment of the economy which will benefit will be lawyers and accountants and those who give tax informational seminars to professionals. My objections to the application of the OID rules to real estate transactions are summarized as follows:

1. The 110% test rate is higher than market and certainly the 120% imputed rate is significantly higher. With long term Treasury obligations yielding in excess of 13.8%, 120% of the federal rate is approximately 16.6% and requiring the imposition of such a rate on real estate transactions involving seller financing is distortionary.

2. The Treasury will realize little additional tax revenue from the imposition of this change in that sellers will be seeking additional tax shelter to shelter the additional imputed interest income and buyers will be having increased deductions for increased interest expense which will more than amply compensate for any depreciation loss through an adjusted purchase price.

3. The administrative costs of imputing this interest on all seller carryback financing transactions will be excessive given the returns to the Treasury.

4. Sellers may refuse to carryback financing and in times of tight money, additional pressure will be placed on the lending institutions and interest rates will increase, producing additional revenue for banks and savings and loan institutions but none for the Treasury.

I commend for adoption by the Senate Finance Committee and Congress an expanded version of what has been reported as HR 6021. In this regard, I would urge you to eliminate the imposition of the OID rules and the imputed interest rules added by new Internal Revenue Code §1272 et seq. as they apply to real estate transactions.

Thank you for your consideration of this letter.

Sincerely,

William A. Falik

William A. Falik

WAF:ls

International
Council of
Shopping Centers
665 Fifth Avenue
New York, N.Y. 10022
212/421-8181

Officers
Board of Trustees
State and Province Directors

STATEMENT OF THE

INTERNATIONAL COUNCIL OF SHOPPING CENTERS

ON THE

TREATMENT OF INTEREST ON

DEFERRED PAYMENT SALES

OF PROPERTY

SUBMITTED BY

WALLACE R. WOODBURY

TO

THE SENATE FINANCE SUBCOMMITTEE

ON

TAXATION AND DEBT MANAGEMENT

August 3, 1984

WASHINGTON COUNSEL
WINSTON & STRAWN
EDWARD C. MAEDER
RICHARD MELTZER
Suite 500
2550 M Street, N.W.
Washington, D.C. 20037
(202) 828-8400

The International Council of Shopping Centers ("ICSC") is the trade association of the shopping center industry. ICSC has approximately 10,000 members consisting of shopping center developers, owners, operators, tenants, lenders and related enterprises. ICSC represents a majority of the 24,000 shopping centers in the United States in 1984.

Prior to enactment of the Tax Reform Act of 1984, the Congress spent over a year considering changes to the treatment of interest in deferred payment sales. ICSC actively participated in the discussion of those proposals and is pleased to present its views on the final version of the rules to the Senate Finance Subcommittee on Taxation and Debt Management.

Much of the immediate reaction to the new rules has focused upon the impact on sales of farms and small businesses. ICSC is sympathetic to the concerns of farmers and --particularly -- small businessmen and women since the majority of ICSC membership is composed of small and medium-size businesses. Nevertheless, ICSC believes very strongly that the new rules on imputed interest in deferred payment sales contain fundamental structural problems that cannot be solved merely by expanding the exceptions for a narrow set of transactions. ICSC urges the Subcommittee to use the opportunity of these hearings to deal comprehensively with the new rules and not to be misled into thinking that broadening a few exceptions will lay the fundamental problems to rest.

The basic flaw in the new rules for imputed interest is that the rationale on which they are based is a highly

theoretical economic analysis of deferred payment transactions. The rationale ignores the enormous variety of transactions that occur in the real world of commercial real estate finance and relies entirely upon an economic model which is often inconsistent with legitimate business concerns.

The new rules for imputed interest seek to achieve symmetrical inclusions and deductions of income and expense by payors and payees. This goal--at best--is inappropriate and--at worst--is harmful in a wide variety of real estate transactions. For example, the goal is frequently at odds with the typical real estate transaction in which the payor of the interest is not the original issuer of the obligation. The symmetrical treatment of income and expense items makes it more difficult for property owners experiencing financial difficulties to negotiate deferral of payments to creditors and other suppliers because the latter will have to pay tax on the deferred payments according to the imputed interest rules. In addition, the requirement of symmetrical treatment virtually eliminates the use of the wrap-around mortgage because the imposition of the imputed rate of interest cancels out the low interest note which is the basis of the wrap. Moreover, the wrap-around mortgage is not a method of tax avoidance but merely the best use of a valuable asset--the low interest note.

Perhaps the most significant effect of the new imputed interest rules is their retroactive reduction in the value of property currently held. The imputed rates will force a seller to reduce the sales price and recharacterize a portion of the

payments as interest. This recharacterization will produce a reduction in the asset base of the seller and a reduction in the price/earnings ratio of the seller. Today's owners of property also will need additional and unforeseen amounts of cash to pay taxes on the sale of their property. If an owner fails to obtain the cash or a buyer cannot provide it, the owner must pay tax on phantom income.

Today's owners also will be discouraged from providing incentives to sell their property to higher risk buyers such as first-time commercial property buyers. Thus, today's owners are penalized because the value of their property is reduced while, paradoxically, tomorrow's buyers are penalized because the incentives which ease their entry into the market are reduced. The ICSC opposes provisions which interfere with the ability of current owners to freely transfer their property, because they create inefficiencies in the economy and diminish economic activity.

The new rules, in addition to producing harmful economic effects, also add an extraordinary new level of complexity to the tax code. The rules are so complex that neither the sophisticated taxpayer nor the average taxpayer has the capacity to determine the "applicable federal rate" or to compute the discount. In fact, the long-term applicable federal rates often are not even published.

For each of the foregoing reasons, ICSC supports the bills introduced by Senator Steven Symms (S. 2930) and Congressman Bill Archer (H.R. 6021) that repeal the recently

enacted rules on imputed interest. The commercial real estate industry and the economy as a whole will be better served if, as Senator Symms and Congressman Archer propose, the rules that existed prior to enactment of the Tax Reform Act of 1984 are restored.

At a minimum, the ICSC urges the establishment of a fixed rate at a reduced level. The current testing rate of 110 percent of the applicable federal rate and the imputed rate of 120 percent do not reflect reality regarding the levels of interest rates freely negotiated at arms' length between a willing buyer and a willing seller today. In certain cases, the rates even exceed the prime rate of interest being charged. It is critical that these imputed rates not be set too high because the seller and buyer are locked into the rates for the duration of sale period. Thus, a rate imputed in today's high interest environment may be very unfair when rates decline to more historical levels.

The testing and imputed rates should be lowered to a fixed, published rate that is approximately equal to 80 percent and 110 percent of the federal rate, respectively. While these rates represent a significant increase in the rates currently charged in many real estate transactions because they are compound rates rather than simple rates, they are more appropriate for a testing rate and an imputed rate than the new rules. The testing rate should establish a floor that allows the parties to negotiate, but precludes them from manipulating the tax rules, while the imputed rate should penalize taxpayers who

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evade the floor. The testing rate in the new rules allows no flexibility between the parties and, instead, substitutes an arbitrary number predetermined to reflect reality. In addition, by fixing the rate, some of the complexity in the new rules is eliminated.

Congress wisely postponed the effective date of the new imputed interest rules until January 1, 1985, in order to give taxpayers an opportunity to evaluate these extraordinarily complex changes. This interim period has already surfaced problems regarding residences, farms and small business. Congress should also take advantage of this interim period to correct more fundamental problems before the January 1 effective date. If these more fundamental problems are not addressed, ICSC believes that the complexities and disincentives of the new rules will reduce federal revenues because significantly fewer transactions will occur. The need for simplicity and certainty in the commercial real estate market is too important to proceed into 1985 with doubts about the vitality of the current testing and imputed interest rates.

DONALD L. KORTZ
ATTORNEY AT LAW

August 15, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Gentlemen:

I wish this letter to be included in the printed record of the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

I have been involved in the practice of law both privately and corporately dealing exclusively in real estate for approximately eighteen years. My practice deals solely in the area of commercial real estate. As such, I am experienced in those areas of governmental regulations which will affect real estate. The changes made to the "imputed interest rules" of Section 483 by the enactment of Section 1274 will create an area that is too complicated to be understood by the average buyer and seller of commercial real estate. In addition to the complications added, the changes have economic impacts as set forth below:

1. By requiring an owner to charge a higher interest rate than he would be willing to give under normal circumstances. The law is in conflict with the government's intent of reducing inflation. As you know, all costs will eventually be passed on to the ultimate consumer which will fuel inflation.

2. In most commercial transactions, the closing of the contract transpires many months subsequent to the execution of the contract. Because of this, the interest rate that the buyer would be required to pay to the seller would not be known at the time of the execution of the contract. If a set interest rate is reflected in the contract, that could be under the then existing rate or if the interest rate is left to fluctuate to be determined at the time of closing, the transaction, because of the economic impact, very possibly could become unworkable. It would seem that there should be a basic rule that a law should be understandable and a taxpayer should be able to measure the tax consequences of their act at the time they entered into an agreement.

3. It seems without reason to require a seller to charge a rate of interest that is in excess of Federal treasury instruments. The rate of interest charged by the seller could be in excess of that of a commercial lender. A commercial lender has a fully operational business staffed by employees and has a significant capital investment. An individual seller does not have these costs. The effect of the rules is that a seller would report interest income much higher than what that same seller would receive from alternative investments.

4. I have always been of the opinion that a buyer and a seller should be able (without governmental interference) to negotiate the terms and conditions of a sales contract. By adding additional governmental requirements and burdens, the effect is of additional costs (ultimately passed on to the consumer) and difficulties in dealing with an individual's property.

5. It would seem that any increase in taxes because of the increase in the seller's interest received will be offset against the buyer's deduction; therefore, there would be no significant increase in government revenue.

Very truly yours,

Donald L. Kortz

DLK:mbk

c: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator Malcolm Wallop
Senator John H. Chafee
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart

TESTIMONY OF

LARRY L. LAIRD

EXECUTIVE VICE PRESIDENT

LIFE CARE SERVICES CORPORATION

before

SENATE FINANCE TAXATION SUBCOMMITTEE

HEARING

of

August 3, 1984

relating to the imputed interest
and original issue discount
provisions of the

Tax Reform Provisions of the
Deficit Reduction Act of 1984

TESTIMONY OF LARRY L. LAIRD

The low-interest loan and original issue discount provisions of the Deficit Reduction Act of 1984 should be amended to exempt payments made by elderly persons for life care in a residential community with on-site nursing care facilities. Residents of such life care communities pay substantial amounts to the community to reimburse the capital costs of providing their apartment and a part of the cost of the nursing facilities and other common areas. The amounts take many forms, from outright interest free loans to wholly or partially refundable entrance endowments, to non-refundable endowments. Most communities today provide for a refund of part or all of the entrance fee, in some form when the resident no longer lives in the facility. Their obligation to refund may, under the 1984 law, be considered a loan, and the resident can be treated as having substantial interest income each year. The resident will then be required to pay income taxes on their "imputed" interest, even though he or she received no actual income. The taxes would have to be paid from other resources.

The result of the new law will either be (1) to cause entrance fees to be made nonrefundable so that they cannot be considered "loans"; or (2) to cause communities to actually pay market rate interest to the residents or other lenders; or (3) to change the life care concept to that of a regular condominium or cooperative housing association with a nursing facility as part of the common benefits.

Each of these alternatives is undesirable. The first obviously penalizes the elderly, or their estates. The second results in substantially increasing monthly charges to the residents in order to obtain funds with which to pay interest. The third puts control of a sophisticated financial, actuarial and sociological enterprise in the hands of elderly people who do not want that responsibility and are unwilling to entrust such responsibility to their "peers".

The most promising of all the private sector strategies for solving the living and health care needs of the elderly, has been the development of "life care" or "continuing care" communities.

Old people are one of the most rapidly growing minorities in the United States. The number of persons over age 65 will increase by 40% by 2025. Those 85 or older will increase 90% by the year 2000. Congress has struggled in many contexts, with problems associated with a "graying" America.

The story is well told in the article by Alan L. Otten in the July 30, 1984 issue of the Wall Street Journal (copy attached). If any conclusion is certain, it is that the public sector cannot by itself solve the problems of caring for our aging population.

The imputed interest provisions jeopardize this creative concept for providing health care to the elderly. As more elderly Americans live longer, a problem of meeting their housing and health care needs at a reasonable cost has become urgent. While many think of retirement as a time for leisure, most elderly

individuals today reach a "second generation" of retirement when their activities slow down and they become concerned about their care should an accident occur or they become ill or senile.

Until recently, an elderly person in an advanced stage of retirement had only two basic alternatives: (1) to return to family members for support or (2) to accept some form of institutional care, such as a traditional nursing home. For those who do not welcome either alternative, the choice has been difficult.

To respond to the needs of individuals who are too independent for institutional care or family support, and who wish to prolong that independency, the concept of "continuing care" was developed. Continuing care is a comprehensive approach to retirement living. It enables elderly retirees to enjoy the lifetime use of a residence and receive long-term nursing care, when needed, in an on-site health center. Residents enter a continuing care community by moving into their own apartment, and, as their health begins to decline, they or their spouse can use the health facilities while remaining in their own "neighborhood". These services are provided on a fixed cost basis and the resident pays a monthly fee to cover upkeep expenses relating to the apartment and all types of medical care.

Continuing Care Communities are Financed Through Front-end Payments

To build these communities, residents traditionally provide the sponsor of the community with a large deposit or lump sum fee which is used to defray the costs of construction and provide for

future medical care. In current practice, most of these "front-end" payments are refundable, although the refund may decline the longer the resident remains in the facility.

The use of these front-end fees permits the residence units and health center to be built with reduced mortgage debt. Approximately twenty percent of the funds are also used to establish a reserve fund for long-term medical care. This financing technique provides fixed income elderly residents with lower monthly operating costs and allows for higher quality medical care at a predetermined cost.

This private sector arrangement has emerged as a creative response to the problem of controlling future health care costs for the elderly in later retirement.

Consumer Protection Measures Exist to Protect Residents

Criticism over the improper use of refundable fees by some within the continuing care industry has sparked efforts to increase the protections given to the elderly retirees who enter these communities.

One response has been the use of interest-free loans as opposed to "refundable" entrance endowments to finance these facilities. In effect, the transaction is the same as requiring a refundable deposit to enter a facility, but characterizing the front-end fee as an interest-free loan enables the community sponsor to give its residents a firm commitment to repay and a perfected security interest in the facility. This provides the

resident with the status of a secured creditor should the community face financial difficulties.

Residents in many existing continuing care communities using refundable fees are not secured creditors. Should any of these homes go bankrupt, the ability of the residents to recover their refundable deposit will be solely up to the discretion of the bankruptcy judge. With an interest-free loan and a perfected interest, residents can protect their investment by being a preferred creditor should the community become financially troubled.

More sophisticated financial management techniques also have improved the ability of newer continuing care communities to refund the full amount of the initial loan no matter how long the resident lives in the community. In addition, the resident is now afforded several additional protections should he or she be dissatisfied in any way with the community after entering it.

As a result of these new consumer protection measures, entering a continuing care community has become analogous to the purchase of a condominium or cooperative but without management responsibility. The resident enjoys many of the same rights of ownership; however, the actual equity interest is left with the community sponsor who is responsible for managing and operating the residence units and health center on a day-to-day basis.

The Deficit Reduction Act Will Destroy This Retirement Concept

The interest-free loan and original issue discount provisions of the Deficit Reduction Act of 1984 (H.R. 4170) jeopardize this

concept for financing continuing care communities. These provisions inadvertently increase the tax liability of those residents who use an interest-free loan or other type of refundable front-end deposit to provide for their future retirement care.

The provisions would treat these loans as interest-bearing transactions and would require each resident to recognize taxable income on the loan, even though no additional income is actually received.

Imputing interest in this manner to fixed income elderly residents will significantly increase monthly costs for these individuals. For example, a retiree may sell his or her home, realizing $120,000 on the equity built up over the years. That money is then used as a refundable fee to enter the continuing care community. If the statutory rate of interest is 10 percent, the amount of interest income required to be recognized for tax purposes will be $12,000 per year. Assuming a 30 percent tax bracket, this increases a resident's cost of living by $300 per month. Higher per month costs also make it difficult for a retirement community to attract new residents as vacancies become available. This will negatively affect both the existing and prospective residents of the community.

Continuing Care Communities are in the process of advising residents and prospective residents of the potential but uncertain, impact on them of the 1984 Tax Act. The lack of certainty is confusing to all concerned, adding to the detrimental impact on these elderly residents and potential residents. No one can

tell them what the impact will be. In the absence of certainty, they become confused and worried about their exposure, and less inclined to assume residency in a life care community, which they would otherwise readily do.

The use of interest-free loans is not for tax avoidance. This financing arrangement allows an elderly resident to live in a retirement community with health care facilities for a reasonable cost without the responsibilities of home ownership which are involved in traditional condominiums or cooperatives.

No Workable Alternative Exists To Provide Financing For These Retirement Communities

Without an exemption from the interest-free loan and original issue discount provisions in the tax law, continuing care communities across the country which seek to protect their residents from unnecessary tax liability will face three choices: (1) decline to refund the loans or lump sum payments which were used by these residents to build and operate continuing care communities; or (2) convert these communities into condominiums and cooperative associations by giving each resident an equity interest in the retirement facility; or (3) pay "interest" on the entrance fees and increase monthly fees to provide the "cash flow" to pay the interest. None of these alternatives is workable.

The first alternative defeats the consumer protections offered by refundable interest-free loans. As stated above, the

continuing care industry traditionally has used nonrefundable or partially refundable fees to build and maintain these communities. By using interest-free loans instead of refundable "endowment" deposits, the resident is able to receive a perfected security interest in the facility. It makes no sense to reverse this and other recent advancements which go a long way to protect a vulnerable class of elderly individuals.

The second alternative of converting these facilities to condominium associations will destroy the very reason why elderly people enter these communities. The reason is that many state statutes regulating the use of condominiums and cooperative associations require that the sponsor of the community transfer management of the facility to the residents once a specified percent of the residence units are sold. The management intensive nature of continuing care facilities compared to the rather passive management requirements of a condominium or coop association requires a far different management format.

The third alternative, as noted above requires increasing the monthly charges substantially, thereby in many cases causing the cost to exceed the ability of the elderly resident to pay it.

People who are in an advanced stage of retirement are attracted to continuing care communities because they offer a combination of independence and security. They are allowed to furnish and maintain their own apartment while also having complete access to health care facilities should they require medical attention. The average age of the residents is typically

over 80 years of age and they look to the sponsor/manager of the community to ensure they are provided for properly for the balance of their lives. Most are widows or widowers.

Turning over the ownership and management responsibilities to residents at such an advanced age invites disaster to these communities. Long-term planning efforts will be jeopardized as the professional managers of the community will no longer be able to guarantee unlimited, essential health care services for the lifetime of the residents. This result would be detrimental to the best interests of the residents and the sponsors of these communities.

The Solution To This Problem Is Simple And Fair

Clearly, Congress should not destroy this innovative health and living concept by imputing taxable interest to fixed-income elderly Americans who participate in these continuing care arrangements.

We urge you to approve a very narrowly defined exception to the interest-free loan and original issue discount provisions of the Deficit Reduction Act. This exception will cover only those loans or lump sum payments made by elderly individuals for the purpose of securing housing accommodations in a continuing care community.

L.3/163-167

PROPOSED AMENDMENT REGARDING CONTINUING CARE COMMUNITIES

The following corrective legislation should be adopted:

Amend Section 41:

This section shall not apply to any loan or lump sum payment made by individuals 60 years of age or older for the purpose of securing housing accommodations for their own occupancy in a continuing care* facility from an unrelated individual, partnership, or corporate entity.

Amend Section 171:

In the case of any interest-free or below-market interest debt instrument issued for or in consideration of any loan or lump sum payment made by individuals 60 years of age or older for the purpose of securing housing accommodations for their own occupancy in a continuing care* facility from an unrelated individual, partnership, or corporate entity, the issue price of each such instrument shall equal the redemption price at maturity of such a loan or payment made by individuals for such purpose.

*Continuing care means the furnishing to an individual, other than an individual related by consanguinity or affinity to the person furnishing such care, of board and lodging together with nursing services, medical services or other health related services, regardless of whether or not the lodging and services are provided at the same location, pursuant to an agreement effective for the life of the individual or for a period in excess of one year.

Larry L. Laird

The Oldest Old

Ever More Americans Live Into 80s and 90s, Causing Big Problems

The Strain on Social Services And Relatives Will Rise; Should Care Be Rationed?

A Five-Generation Family

By Alan L. Otten
Staff Reporter of The Wall Street Journal

"A 75-year-old patient of mine died the other day," says Joanne Lynn, a Washington, D.C., geriatrician. "The real tragedy was that he'd been taking care of his 95-year-old mother at home, and now she has no one."

"An elderly friend of mine was in a nursing home for eight years," relates Ethel Shanas, a gerontologist at the University of Illinois at Chicago. "Her son was putting his own son and daughter through college—and, at the same time, having to pay some of her nursing-home bills. That's a lot of pressure to put on one person."

By now, almost everyone is aware of "the graying of America"—the fact that a steadily increasing percentage of the U.S. population is living past 65, the long-accepted benchmark for entry into old age.

What is dramatically new and worrisome about that fact is what one expert calls "phase two of the gerontological explosion"—the aging of the aged. As society learns better to stave off heart disease, strokes, cancer and other killers, more and more Americans, and an increasing percentage of the total population, are living not just past 65 but on into their 80s, 90s and beyond. Men and women 85 and over constitute the fastest growing age group in the U.S.

The Problem Group

It is these "oldest old"—often mentally or physically impaired, alone, depressed—who pose the major problems for the coming decades. It is they who will strain their families with demands for personal care and financial support. It is they who will need more of such community help as Meals on Wheels, homemaker services, special housing. It is they who will require the extra hospital and nursing-home beds that will further burden federal and state budgets.

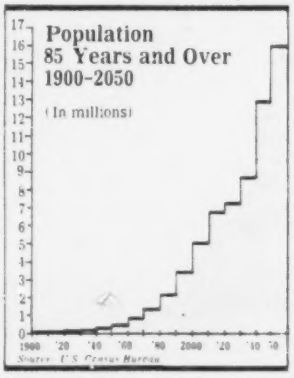
And it is they whose mounting needs and numbers already spark talk of some sort of rationing of health care. "Can we afford the very old?" is becoming a favorite conference topic for doctors, bioethicists and other specialists.

"Eighty-five is a kind of turnaround point," says Elizabeth Kutza, a social-policy analyst at the University of Chicago. "After that, the problems come faster: How he-thy will I be? Who is going to be around to take care of me? How do I keep the income directly going?"

There are, of course, frail and ailing 65-year-olds and 70-year-olds, but most of today's "younger old" are healthy, active, relatively well-off—really more middle-aged than old. On the other hand, though a few Alf Landons and Ellsworth Bunkers remain active and alert in their 80s and 90s, somewhere in their 80s most of the surviving old begin to show their age.

"The average 85-year-old today has a longer life expectancy," says John W. Rowe of the Harvard Medical School, "but that life expectancy is dominated by disability."

Census Bureau figures tell the startling story. In 1940, only 365,000 Americans were



85 or over, a mere 0.3% of the total population. By 1982, the number had zoomed to 2.5 million, or 1.1% of the population. By the end of this century, only 16 years from now, the bureau predicts, this oldest old group will top 5.1 million, almost 2% of all Americans. By 2050, after the postwar baby-boomers have all reached the highest age brackets, more than 16 million men and women will be 85 or over, some 5.2% of the population.

Five Generations

By the year 2000, more than 100,000 Americans will be 100 or over, three times the present number. Four-generation families are already commonplace, and five-generation families have begun to turn up. James Birren, who heads the University of Southern California's gerontology center, tells of a friend who on the same day visited her grandmother in a nursing home and then baby-sat for her infant granddaughter.

The current surge in the ranks of the oldest old stems primarily from the increased numbers of children born and surviving in the late 19th and early 20th centuries, and secondarily from declining deaths from epidemics, heart attacks, strokes and other diseases that used to kill people in youth or middle age. Since 1900, average life expectancy at birth has lengthened more than 50%—from 49 then to almost 75 today.

In the past few decades though, mortality rates for the elderly have been dropping faster than those for other age groups. Earlier changes in life style and improved medical treatment get the credit. Women have benefited especially; they are outliving men by steadily widening amounts. In 1980, there were 80 men for each 100 women aged 65 to 69, but only 44 men for each 100 women in the 85-and-over bracket. As Peter Morrison, a Rand Corp. demographer, puts it, "Aging is disproportionately a woman's problem in our society."

Even now, society knows comparatively little about the special problems of the very old. To begin filling in the gaps, the federal government's National Institute on Aging is proposing to underwrite dozens of research projects into the health, income, housing arrangements and other aspects of the life of the oldest old.

"The condition of the very old today is like an 18th-century map of Africa—huge areas marked terra incognita," the NIA's Richard Suzman says. "There isn't that much data, and the quality of much of it is terrible."

Health

Even at age 85 or 90, today's elderly are unquestionably healthier and more active than their predecessors. As they become very old, however, they obviously are also increasingly likely to suffer from chronic illnesses or other disabilities that require increasing care for longer and longer periods.

"From the population of very old people come most of the million and more who are so disabled that they require round-the-clock care in nursing homes, the two million who are equally disabled but who are not in institutions, and many of the six million more who require less intensive services," says Elaine Brody of the Philadelphia Geriatric Center.

Among the most incapacitating chronic conditions are Alzheimer's disease and other types of mental impairment, with their progressive loss of memory, disorientation and inability to function alone. They become more common with advancing age and are the major cause of institutionalization.

Rising Risks

"Dementing illness roughly doubles every five years after 65," says Carl Eisdorfer, a geriatric psychiatrist who heads Montefiore Medical Center in New York City. "About 1% show it at 65, 2.5% at 70, 5% at 75, 12% at 80, up in the 20s at 85, and 40% to 50% in the 90s."

Other chronic problems that strike with increasing frequency and severity as the old grow very old include arthritis, limiting heart conditions and hypertension, and osteoporosis (brittleness of the bones). Incontinency, problems with hearing and vision, and depression and other mental strains also become common.

"But the real name of the game for the very old is multiplicity of illnesses," says Robert Butler, the head of the Department of Geriatrics at the Mt. Sinai School of Medicine in New York. "It gets called frailty and other things, but it's really multiplicity."

With chronic conditions added to acute health problems, the very old use medical resources disproportionately. Robert Bin-

stock, the director of the Policy Center on Aging at Brandeis University, estimates that per-capita hospital spending of the 65-and-over group is more than 250% higher than that of the under-65s, with the 85-or-over group 77% higher again. The super-old also fuel the nursing-home explosion; the government says that only 6.4% of the 75-to-84-year olds are in nursing homes but 21.6% of the 85-or-over group are.

Finally, those very old who aren't in institutions still require lots of family and community care. Barbara Feller of the National Center for Health Statistics estimates that one in 10 men and women between 65 and 75 need another person's help in everyday activities but that four out of 10 need such help at 85 and over.

"People are undoubtedly living more healthy years," says Jacob Brody, an NIA associate director, "but the problem is they are living more unhealthy ones, too."

Government Spending

Barbara Torrey, a government economist who has studied the elderly, estimates that the government now is providing $51 billion in payments and services just to people 80 and over and that, by the year 2000, it will be paying $34.3 billion more (in 1984 dollars) solely because of the increasing numbers of the very old.

Medicare's hospital-insurance fund is currently projected to run out of money around the end of this decade. The chief cause has been inflation in hospital and other medical costs, but "the growing number of old people certainly exacerbates the problem," says Michael Boskin, a Stanford University economist.

The Reagan administration says there is an urgent need to either raise payroll taxes or reduce Medicare benefits. Both courses are politically explosive.

Only to a limited extent does Medicare help pay for nursing-home and other long-term care. Medicaid, a needs-based system financed partly by Washington and partly by each state, helps pay those costs for impoverished old folks, and it has been one of the most rapidly growing state outlays. Many states are trying to cut back eligibility, and a few are considering the possibility of making children pay at least part of the long-term care bills of their needy parents.

Many experts think that money could be saved by keeping frail old people at home rather than in institutions: more Meals on Wheels, visiting nurses and homemakers, and transportation services. "This is cheaper and more humane," argues Jack Meyer of the American Enterprise Institute.

Other specialists think that Medicare must ultimately be extended to cover nursing homes, community services and other long-term care. "Medicare was supposed to protect the elderly against catastrophic expenses," says Rosalie Kane of Rand Corp., "and this is the most catastrophic of all."

Personal Finance

The current generation of old people, most economists agree, is generally far better off than any of its predecessors. They have more wealth in homes, cars and savings. Inflation-adjusted Social Security, private pensions and special tax breaks have increased their after-tax income. Twenty years ago, one in four over-65s was below the poverty line; now, one in seven is.

But the oldest old may find their pensions exhausted and health bills eating into savings. Mrs. Torrey says the average income of the 85-and-over group is at least one-third less than that of people between 65 and 70.

More and more, expert opinion is challenging the trend toward early retirement, questioning whether early retirees realize how much longer they are likely to live and how much more money they might need. The Senate Committee on Aging says the proportion of the average man's life spent in retirement has increased from 3% in 1900 to an astonishing 20% in 1980.

"People are going to need an enormous increase in their assets to maintain their standard of living for so many years," Stanford's Mr. Boskin says.

Family Burdens

Despite the widespread image of families dumping aged parents into nursing homes, surveys show that most frail elderly are still outside institutional walls and that a spouse, child or other relative is still the chief caretaker.

"Family responsibility is doing well so far, but can it stand up to all the strains and demands we may soon be putting on it?" asks Mrs. Shanas, the Chicago gerontologist.

Support for the very old may have to come increasingly from children approaching retirement or already retired and dealing with their own health problems. Many of the middle-aged may encounter simultaneous demands to support a parent in a nursing home and to put children through college. Daughters and daughters-in-law, the traditional caretakers of the elderly, are today far more likely to be employed, unwilling or financially unable to give up work to help an aged parent.

"Women used to drop out of the labor force to care for their kids," observes Cynthia Taeuber, a Census Bureau demographer. "Now, they're facing the need to drop out to care for an aged mother."

Divorce, remarriage, single-parenthood and other changes in family patterns all are blurring lines of family responsibility. For example, the high divorce rate lessens chances that an elderly woman—men are more likely to remarry after divorce or death of a spouse—will have a helpmate when she needs one.

Experts on aging also worry about the possibility of sharpened intergenerational conflict ahead, as low fertility rates provide fewer working-age taxpayers to meet the growing needs of the elderly.

Bioethical Choices

Super-longevity and rising health-care costs have almost inevitably sparked discussion of rationing health care to the very old: no kidney dialysis or liver transplants after 55, for example.

"The problem is age-old and across cultures," says Dr. Eisdorfer of Montefiore. "Whenever society has had marginal economic resources, the oldest went first, and the old people bought that approach. The old Eskimo wasn't put out on the ice floe; he just left of his own accord and never came back."

Jerry Avorn of the Harvard Medical School says he now hears young doctors and interns say, "It's not cost-effective to perform that operation—he's too old." A group of 10 doctors recently published in the New England Journal of Medicine a set of guidelines on when to decrease "aggressive treatment" of the hopelessly ill.

Still, doctors and experts on aging overwhelmingly believe that the U.S. is still a long way from embarking on any formal rationing of health care by age. "It is very dangerous to develop age criteria for excluding people, and I'm dead against it," says Edward Schneider, another NIA associate director. Observes Dr. Avorn sarcastically: "Euthanasia at retirement would be the most cost-effective of all."

Rec'd

MINNESOTA FARMERS UNION

Office of the President

August 2, 1984

The Honorable Bob Packwood
United States Senate
259 SROB
Washington, D.C. 20510

Dear Senator Packwood:

I am writing you today concerning the issue of imputed interest rates under the 1984 Tax Bill. I understand the subcommittee you chair, the Subcommittee on Taxation and Debt Management, will hold a hearing on this matter tomorrow morning.

As you are well aware, several attempts have been made since 1981 to increase the imputed interest rates on farmland transactions between related and non-related parties. The 1984 Tax Bill mandates further change to the law effective January 1, 1985. Under the law, current imputed interest rates between non-related parties would increase from 9 percent to the rate equal to 110 percent of T-bill rates at the time of sale.

It is the position of Minnesota Farmers Union that this law would have the effect of increasing imputed rates from the current 9 percent to more than 15 percent by next January. The magnitude of the increase would stifle already dismal land sales in Minnesota and other states, particularly since the majority of farmland being sold today is sold under a contract for deed arrangement.

I am aware of several amendments that may be offered to S. 2894 during the hearing tomorrow. Minnesota Farmers Union supports those provisions of the Melcher bill that pertain to farmland sales between non-related parties with one exception. We are concerned the upper exemption limit of $1,500,000 is more than would be necessary in Minnesota. An upper level exemption of $1,000,000 may be more appropriate in relationship to the average price of our land and our average size farm.

The difficult situation facing family farmers should cause quick action on this issue by the Senate. The effect of a 15 percent imputed rate on farmland sales would be devastating to our already depressed land market and would virtually end any opportunity for an older farmer to sell his farm to a younger, non-related neighbor.

Sincerely,

Willis Eken

Willis Eken
rmj

cc Senator Dave Durenburger
Senator Rudy Boschwitz

1717 University Avenue • St. Paul, Minnesota 55104 • Phone 612-646-4861

NATIONAL FARMERS UNION

STATEMENT
OF
CY CARPENTER
PRESIDENT
NATIONAL FARMERS UNION

PRESENTED TO

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

CONCERNING

S. 2894 - TO CLARIFY THE APPLICATION OF IMPUTED INTEREST

AUGUST 3, 1984
Washington, D.C.

We are concerned with the impact on farm families of the provisions in the 1984 Tax Act that raised the "imputed interest rates" on seller-financed sales of small businesses, farms, ranches and homes to 110 percent of the U. S. Treasury Department securities with comparable maturities. We recognize there is an amendment to permit contracts to be written at 9 percent for sales of farm and ranch land under $1 million and for sale of principal residences under $250,000. Even so, we believe this provision will have a depressing effect on rural businesses and many farm families.

Equity in a farm most often represents a farm family's retirement income. They should be able to sell to the next generation of farmers at rates which allow at least a chance to meet expenses and make mortgage payments. Beginning farmers must often look for private financing to get a start in farming. It seems to us that the rigid intrusion of the Internal Revenue Service into such private financing interferes with normal commerce. It might also make more difficult a profitable farm or small business operation that could produce earnings taxable under regular income tax provisions.

A common method of transferring real estate in many states, is by means of long-term deferred payment contracts between the transferor and transferee. This is especially true in the case of intra-family transfers; for example, between a father who is gradually phasing out of the operation and management of the family farm and a son who at the same time is gradually phasing into the operation and management of that same family farm. This sort of contract has advantages to both parties because it can be a source of retirement income to the parents and it allows the seller to take advantage of Internal

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Revenue Code Section 453. It gives the beginning farmer the opportunity to spread payments over a period of time while he is getting his feet on the ground.

Recognizing the widespread use of such property transfer device and in order to encourage transfers to beginning farmers, a number of states provide for special tax treatment for an individual taxpayer's state income tax when such sales are made. The increase in imputed interest rates by IRS may well invalidate such state efforts to help continue a family farm structure of agriculture in the United States.

An increase in imputed interest rates adds pressure to continuing high rate schedules and comes at a time when land values in many states are severely depressed and small business in rural communities is rocking from the depressed farm economy. Such developments as the recently organized Chicago-based Consolidated Family Farms which propose to buy out farmers at these depressed prices and rent the farms back to them seems to me another threat to America's historic support of family farms.

High interest rate levels are damaging to agriculture in several significant ways -- they divert consumer buying power from food and other household necessities and they are a factor in the overvaluing of the American dollar which hinders the export of U. S. farm commodities.

Interest outlays by American farmers totaled $21 billion in 1983, about equal to their total net farm income. On January 1, 1984, the outstanding debt of U. S. farmers totaled $215.1 billion.

Recently President Reagan has expressed concern that it would be too costly and damaging to allow the foreign debt problems of Argentina, Brazil and Mexico to deteriorate further.

American farmers owe twice as much as the combined external foreign debt of those three countries. You would have to add the external debt of Algeria, Egypt, India, Indonesia, Israel, Korea, Turkey and Venezuela to equal the outstanding debt of U. S. farmers.

Each one point increase in the prime lending rate eventually translates into $2 billion in added outlays by farmers. That is to say, recent increases from 11 percent to 12 percent in the prime rate will cause operating outlays to rise by $2 billion for the year.

The increase in the prime rate from the 6 1/4 percent level in early 1977 to present levels thus can be seen to divert $12 billion a year from the income to the outgo side of farm ledgers.

Farmers Union members have had a continuing concern with the action of the IRS in raising imputed interest rates, as our testimony to the Senate Finance Committee hearings in 1980 and 1981 explained in detail to delegates at our March 11-14, 1984, National Farmers Union Convention held in New Orleans, Louisiana, March 11-14, 1984, adopted the following policy statement on this issue:

"N. IMPUTED INTEREST RATES

Imputed interest rates for tax purposes of not more than 7 percent under Section 483 of Internal Revenue Service regulations have been severely limited to apply only to sales of $500,000 or less in real property between members of the same family. A contract for deed at privately agreed-upon interest rates is a common vehicle for sale of farms from retiring to beginning farmers. Action taken through the tax bill removes this option for all but immediate family members. It also interferes with state laws and other efforts which provide special tax incentives designed to encourage farmland transfer to beginning farmers.

We urge Congress to prohibit intrusion of the Internal Revenue Service into these private transactions by reinstating the previous regulations which limited to no more than 7 percent imputed interest rates on transactions on nondepreciable property. Although interest rates have fallen from previous high levels, there is no indication that the Treasury Department will voluntarily move to lower the increased imputed interest rate levels."

We believe S 2894 will address some of the more urgent aspects of this issue and urge your Committee to report it favorably with the recommendation for prompt enactment by the Senate.

M

Moore
and company
REALTOR®

August 16, 1984

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

Following are our Company's comments concerning the imputed interest rules of Code Section 483 and New Code Section 1274.

We are very concerned about the complexity of the changes made in the imputed interest rules of Section 483 by the enactment of Section 1274.

The present value computations of Section 1274 evidently were based upon a single principle payment bond, however, we are engaged in real estate sales, which generally provide for either an amortizing loan with a specified interest rate and monthly or annual payments over a period of years, which can extend for 10 to 30 years. Also, such loans often provide for an amortization period of up to 30 years with a balloon payment at the end of 10 years or other period. Another manner in which real estate may be sold is equal annual payments of the principal amount for a period of years and interest on the unpaid principal balance.

In attempting to actually calculate some samples of a typical real estate transaction, with a less than target rate interest rate it appears that a significant portion of the imputed interest would arise in the first year. If this is true, then subsequent annual payments of the actual loan rate could result in negative imputed interest although it is difficult to determine how this would be handled.

Because of the extreme complexity of these transactions, it will be necessary for every taxpayer to have attorneys and CPA's handle all of their transactions since it will be almost impossible for any owner of a property to do any of these calculations themselves. Because of the complexity of calculation, it will be almost impossible to do them without a computer.

At one point in time, 120% of the interest rate charged on federal treasury instruments would probably have been less than commercial loans for a comparable period of time. Unfortunately, today, it may be possible to obtain a commercial loan at less than that rate.

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One of the main reasons that a seller of property is willing to carryback a loan at a lower rate than a rate that may be obtained from a commercial lender is because the individual knows the property and understands what would have to be done if the property were foreclosed upon and taken back. Also, the seller of the property is looking at alternative investments and is willing to lend the money at 2-3% less than a commercial lender because this would, in most cases, be more than that individual would be able to obtain in interest income from another source. Also, a commercial lender is not only paying to borrow the money that that lender is relending, but has a substantial staff involved both in the acquisition of funds to be loaned and in the acquisition and servicing of the loan itself. This differential is 2-3 interest points above the cost of actually acquiring the funds to be loaned. The individual selling the property does not have these costs so is generally willing to loan the money at 2-3% less than the commercial lender.

Both buyers and sellers of real property wish to know the interest rates that they will be operating under since it affects the economics of the transaction. Because of the long periods of time required between the date of contract and closing of a significant real estate property, in many cases six months to a year, the interest rates could change dramatically due to fluctuations in the treasury's ability to borrow which is beyond the control of either the seller or purchaser. This may mean that all transactions would end up with an escape clause allowing either the purchaser or seller to void the contract should 110% of the applicable federal rate be different at the time of closing rather than at the time the contract was entered into.

The tax effect of this change does not appear to be very significant. The seller would have ordinary income to the extent of the interest and the buyer would have an ordinary deduction to the extent of the interest expense. On the purchase and sale of any significant property both would probably be in similar income tax brackets. Therefore it would appear that if Section 1274 cannot be repealed, the testing rate should possibly be 80-90% of the applicable federal rate rather than 110% and the penalty rate should be the applicable federal rate. It would also help if the rate used were that at the date a contract of sale is entered into, not at the date of closing of a real estate transaction.

One other problem arises in some states when this type of rate is applied. It may be above the state usury rate and could not actually be charged by the seller.

Our primary concern about the law is the complexity of it and the fact that most taxpayers, let alone Internal Revenue Service Agents, tax attorney's and CPA's would not be able to understand the actual application of the law. Since our system theoretically operates on a self- assessment basis, to develop such a complex law on what are common recurring transactions does not appear to foster compliance.

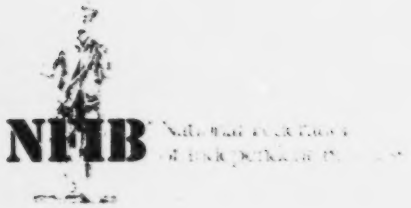
I would appreciate your consideration of our comments in connection with the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

Yours very truly,

MOORE AND COMPANY

Robert D. Williams
Secretary-Treasurer

RDW/mjd



STATEMENT

SUBMITTED BY

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

To: Senate Finance Committee

Subject: Imputed Interest Rules

Date: August 3, 1984

On behalf of the more than half million members of the National Federation of Independent Business (NFIB), we appreciate the opportunity to present the membership's views on a legislative proposal to clarify the application of the imputed interest rules in the case of a sale of a small business.

This issue surfaced as a result of passage of new rules on unstated interest and original issue discount in the recently enacted "Deficit Reduction Act of 1984." Prior law provided special rules for certain deferred and payment transactions which were not subject to the old OID rules.

If the parties to a deferred payment transaction did not specify a minimum rate of interest, a portion of the principal could be recharacterized as interest using an imputed rate of interest higher

than the safe harbor rate. Section 483 of the Internal Revenue Code specifies the safe harbor rate as 9% and the imputed rate as 10%.

The expansion of the OID rules results in decreased availability of the old safe harbor rules under Section 483, unless a transaction is specifically excluded from the OID rules. Exceptions do exist for seller-financed sales of principal residences if the principal amount is not in excess of $250,000 and for owner-financed sales of farms where the principal is not in excess of $1 million.

The new OID rules become effective January 1, 1985, therefore timing is of the essence.

The concern over imputed interest rules is that they impact directly on small business much in the same way that initial capitalization problems affect small business. Small business has always faced a shortage of available capital for financing new and expanding small firms, and financing the sale of a small business presents similar obstacles. Long-term financing is generally unavailable to both new businesses and buyers of small businesses unless the buyer is in a position to offer a substantial amount of personal guarantees. Often the major asset of a small business is intangible, and a bank will find it difficult to lend the buyer sufficient funds to facilitate the purchase unless the buyer provides a personal guarantee.

To the seller of a small business who may wish to retire, the available market for his business is usually severely limited because of the inherent risks of buying a small business. Seller financing is often an integral part of the package necessary to facilitate a sale.

The seller often agrees to accept a below market rate of interest on deferred payments because paying market rates may be unrealistic for the buyer, who must both pay off the obligation to the seller and have enough left over to finance improvements in the business and possibly to finance expansion and growth. The seller recognizes this problem and is willing to accept the lower rate and the financial loss it presents to him.

Senators Melcher, Baucus, and Boren are to be congratulated for recognizing the severe impact that the imputed interest rules may have on sales of small businesses. We feel that the legislative proposal they have made solves the problem for those small firms under $500,000 in value.

If we existed in a financial world in which all factors were equal, application of the imputed interest rules in large and small cases would be fair. However, we are not living the dream of Adam Smith, and large firms do possess financial leverage small firms lack. Large firms can resort to various tax advantaged financing

methods, while small firms cannot. In fact it is of paramount importance for the seller of a small business that the buyer survive. If the buyer doesn't survive, the deferred payments stop, and a lifetime of effort plus his own financial security is wiped out.

NFIB supports the efforts of Senator Melcher and his cosponsors to allow for a small measure of equity in the imputed interest rules, and we thank you for the opportunity to make you aware of NFIB's position on this legislation.

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Testimony

of

Scott L. Slesinger

National Apartment Association

before the

Subcommittee on Tax and Debt Management

Senate Committee on Finance

on

"TREATMENT OF INTEREST IN DEFERRERED PAYMENT SALES OF PROPERTY"

August 3, 1984

Mr. Chairman, my name is Scott L. Slesinger, Executive Vice President of the National Apartment Association. (NAA). I appreciate the opportunity to appear here today to present NAA's views on the provisions in the Deficit Reduction Act of 1984 dealing with deferred payment transactions.

The National Apartment Association is a trade association representing nearly 50,000 owners, builders and managers of some two million apartment and condominium units across the country.

The so-called OID rules in the 1984 tax bill involve a complex set of rules to measure the interest element in deferred payment transactions. The rules are based on the assumption that deferred payments should be recharacterized as if the parties had based the yield to maturity on an applicable federal rate.

The OID rules represent a response to abuses of prior law which enabled parties to grossly overstate the principal element of a transaction and to take advantage of the ability to mismatch the deductions claimed by the purchaser of property with the reporting of income by the seller.

We agree that, in certain cases, low interest rates can be a vehicle to increase the depreciation deductions. However, those cases are overshadowed by the normal operations in commercial real estate where interest rates move far slower and less dramatically than money market rates. For instance, in 1981, when interest rates exceeded 20%, real estate was never sold at mortgages that high. The owner financing we received fluctuated in the 7-15% range or the property was illiquid and did not transfer. This law will stop real estate transations, when rates increase. Rents cannot go high enough to cover the financing costs. If they did the rental would be unaffordable to the poor and the middle class would move to the tax benefits available as homeowners, assuming they could afford one.

Nevertheless, even if one does not dispute the underlying economic theory of the OID rules, it must also be recognized that the tax law must be practically administrable and conform to the reasonable expectations of persons engaged in everyday transactions. There are many practical compromises in the Code that reflect the understanding that pure tax and economic theory does not always make good tax law, such as permitting the use of the cash method of accounting, not taxing the imputed income of owner occupied residences, non taxation of certain in kind fringe benefits, and numerous others.

The sale of residential real estate is an area where it is important that the tax law apply in a manner that meets

the parties reasonable business expectations. Tax laws that discourage sales will also discourage the necessary rehabiliation expenses since the owner and more importantly his lender will be wary of investments that would be difficult to liquidate.

During the past three years, there have been dramatic increases in investment in rehabilitating multifamily housing. A significant portion of those investment funds come from new owners who are able to pour money into rehabilitation precisely because they are not made "cash poor" by the transaction. Several of our members have purchased for investors distressed properties, where neither the rents nor the condition of the building would cover needed rental increases to pay for necessary rehabilitation. Banks traditionally are not likely to make rehabilitation loans on questionable properties. Consequently, the owner is usually the only person with the knowledge of the property and the investment to realize that such owner takeback financing is the only practical way to provide the new owners with the financial capability to finance needed rehabilitation. By purchasing the building with a low owner-financed interest rate, our members have been increasing the tax base and making use of the substantial infrastructure in the property.

Such transactions will not be feasible under the imputed interest rate rule.

Moreover, in an imperfect market, if parties are bargaining at arm's length, numerous factors may affect the

interest rate which a willing seller will accept from a willing buyer. Therefore, no single arbitrary rate can never represent the true market rate. Indeed, President Reagan has said on numerous occasions during the past year that real interest rates are far in excess of justifiable rates, given the current low rates of inflation and yet it is precisely such inflated interest rates on which the OID Rules are based. In the real world, a seller will be concerned about the illiquidity of his, or her real estate investments, weighing numerous factors and alternative investments --many of which may not be performing as well as an investment in government securities --in determining an acceptable interest rate.

Even more important, from the standpoint of the members of the NAA, are the cash flow considerations that stem from the imputation of the applicable Federal rate to both a buyer and seller of multifamily residential real estate. To the extent that sellers will be required to recognize income at such rates, buyers will be required to actually pay interest at such rates -- it is very unlikely that sellers will agree to be subject to tax on phantom income. This, in turn, will mean that buyers will have to charge higher rentals to tenants in order to obtain the cash flow necessary to pay such interest to the seller. In a typical example where 50% of the financing is from a bank and 30% is in the form of owner financing that would now require an interest charge of about 15% rather than 10% In a typical real-world example, the impact to residents would be significant. We estimate that rent will have to increase about

$300 per apartment a year, making 1 million renters unable to lease without subsidy. Inevitably, increased rental costs will decrease the supply of affordable rental housing for those lower and middle class families most in need.

The Committee has already recognized the impact of applying the OID Rules to owner-occupied housing by excluding sales of principle residences, and sales up to 250,000 from the OID Rules. We believe that a similar exemption should be given for rental housing. Without an exemption, the cost of housing will increase.

Given these factors, we believe that the Committee should adopt a more reasonable set of OID Rules in the case of non-abusive sales of residential real estate. We strongly oppose the exceedingly high rate at which interest must be imputed in every single case that deviates from 110% of the applicable federal rate. We urge that there be an exemption for rental real estate for non-abusive cases that would allow the parties arm-length bargaining to apply, if the stated interest is at least 70% of the applicable federal rate, if it is secured by the property.

In cases where parties act reasonably, the tax law should not intrude to rewrite contracts of small business persons and investors who are not armed with a battery of tax lawyers, accountants and actuaries. We believe that this limited exception will protect against abuses, while at the same time permit market forces to determine an economically realistic rate of interest, without causing rental rates to skyrocket. We strongly urge you

to adopt such an exemption and are willing to work with the Committee to develop appropriate legislative language for this proposal.

NATIONAL LUMBER AND BUILDING NLBMDA MATERIAL DEALERS ASSOCIATION

September 29, 1983

The Honorable Robert Dole
Chairman, Senate Committee on
Finance
United States Senate
Washington, D.C. 20510

Dear Senator Dole:

The National Lumber and Building Material Dealers Association would like to submit to you and the members of the Senate Finance Committee our views and concerns on the legislation you recently introduced entitled the "First Time Homebuyer Assistance Act of 1983", (S. 1598). We respectfully request that this correspondence be included in the Committee's hearing record.

NLBMDA is a federated association representing twenty-six state and regional associations and over 10,000 lumber and building material dealers. A majority of these dealers operate family run and single community based small businesses, providing materials to both individual consumers and building contractors. The lumber and building material dealer serves as a key element in the housing industry, representing the merchant intermediary between the building material producers and the homebuilder. In fact, many lumber dealer operations are diversified to include wholly-owned building contractor and real estate developing companies. In 1983 the lumber and building material industry is expected to provide approximately $60 billion worth of material ranging from framing lumber to roofing products to the American housing industry and the American consumer.

Mortgage Revenue Bonds (MRB)

NLBMDA is pleased to give you our recommendations on S. 1598. Our industry, because of our strategic position as the provider of lumber and building materials, has been intricately involved in the general area of tax-exempt bond financing for the benefit of first time homebuyers. We support legislation in the House and Senate which eliminates the December 31, 1983 "sunset" provision placed, as a result of the Mortgage Subsidy Bond Tax Act of 1980, on Federal tax exemption for single family housing bonds. NLBMDA continues to support elimination of this bond "sunset" provision for two important reasons.

40 Ivy Street S.E. • Washington, DC 20003 • (202) 547-2230

First, NLBMDA recognizes that the tax-exempt, single-family mortgage revenue bond program serves an essential function by providing homeownership opportunities to qualified families who otherwise would not be able to afford a home. Secondly, NLBMDA views the mortgage bond program as a significant countercyclical home financing tool during times of extremely high conventional mortgage interest rates. The mortgage bond benefit was especially valuable during the recently ended housing slump. Between 1980 and 1982, in many localities, mortgage revenue bond financed housing was "the only game in town" as far as new housing construction was concerned.

Perhaps the most significant provision in S. 1598 is actually not included in the draft bill. This, of course, is the implied assumption in the legislation that the tax-exempt feature for single-family mortgage revenue bonds will be maintained beyond the current December 31, 1983 sunset date. Being practical business owners, lumber and building material dealers are true advocates of the philosophy of not altering an already proven and effective program. Notwithstanding legitimate, cost effective arguments surrounding the existing mortgage revenue bond program, one must recognize that these tax-exempt bonds do result in considerable housing construction and rehabilitation. Any housing proponent would be reluctant to shelve a program which is expected to generate over $16 billion for housing finance purposes.

Mortgage Credit Certificate (MCC)

Our continued support for the mortgage bond program however does not necessarily preclude our support for additional or alternative Federal first time homebuyer's assistance programs. NLBMDA avidly supports your efforts to make federal assistance in this area more cost effective. It is a disturbing fact associated with the existing mortgage revenue bond program that many millions of dollars which escape Federal government tax collection are used for non-housing related expenditures such as expensive bond selling procedures and legal fees, instead of being more directly utilized for assisting first time homebuyers. The mortgage credit certificate program envisioned in S. 1598 solves this major stumbling block by more effectively using Federal tax expenditures than the existing mortgage revenue bond program.

MCC Reporting

NLBMDA is also extremely supportive of the approach taken in S. 1598 which would require increased public reporting requirements on efforts by the state and local governments to assist first time homebuyers. Much of the uncertainty which is associated with the mortgage bond program is directly attributable to the lack of hard numbers, whether it be Federal tax expenditure losses, actual interest reduction assistance for homebuyers or other important statistics which might provide important policy setting information. Improved reporting and statistical accounting would provide Congress and housing proponents with the flexibility to increase or decrease Federal assistance on this area based upon hard, unquestioned facts.

MCC Refundability

NLBMDA supports the language in the draft legislation which would allow the holder of a mortgage credit certificate to receive a tax refund should the assisted homebuyer not have sufficient tax liability to take full advantage of the mortgage credit. This well-planned, refundable credit approach would ensure that the proposed assistance program would be attractive for and targeted to even lower income families than those who would otherwise be assisted under a non-refundable tax credit program.

The provisions in S. 1598 which would separate mortgage interest rate deductions from the mortgage tax credits taken by the assisted homebuyer in his individual tax return are also well conceived, we believe. Avoiding any "double dipping" abuses associated with a tax-related assistance program is a sound and laudable goal, especially during the existing Federal deficit crisis.

Upon analyzing the proposed legislation, NLBMDA has several recommendations which we feel would improve the proposal's effectiveness in providing help to first time homebuyers.

MRB/MCC Tax Credit Level

First, the Committee should carefully analyze the tax credit level currently set in the draft legislation at 14.35 percent, and determine if this level, which is based upon benefits associated with the existing mortgage revenue bond program, needs to be changed. Separate determinations have

indicated that mortgage bonds reduce mortgage rates by more than the 14.35 percent level envisioned in the legislation. For example, using Federal Home Loan Bank Board statistics based on conventional rates, the National Association of Home Builders has estimated that a more accurate tax credit level should be set at 21 percent. NLBMDA urges the committeee to reevaluate this important factor and amend the legislation to make this crucial tax credit level 100 percent accurate based on the spread between conventional ~~national~~ mortgage rates and mortgage rate assistance provided under the mortgage revenue bond program.

Mortgage Capital Formation

NLBMDA is concerned that the newly-proposed mortgage credit certificate program, representing a credit program directly transferable from the Federal government to qualified first time homebuyers, does not effectively "create" new capital for mortgages. The existing mortgage revenue bond program does perform this particular housing capital formation function through the sale of tax exempt bonds in the investment markets. Without changing the basic thrust of the legislation which attempts to streamline Federal assistance to homebuyers and thereby reducing administrative and program costs now associated with the mortgage revenue bond program, NLBMDA recommends that the legislation be amended to permit Federally chartered secondary market agencies to buy home ~~mortgages~~ which are assisted by the mortgage credit certificate program. The adoption of this type of amendment would greatly assist in insuring mortgage liquidity, while at the same time resulting in some generation of mortgage capital to offset the reduction in production of capital when state housing authorities "trade in" mortgage revenue bond authority for mortgage credit certificate authority.

MCC Administration

NLBMDA strongly recommends that the legislation be amended to clearly designate the administration of the new mortgage credit certificate program to state and local housing finance agencies. These agencies have proven over the years to be highly qualified and effective in administering bond programs for both multifamily and single-family housing. State and local tax exempt housing bond ~~volume~~ this year is expected to exceed last year's volume of $15.76 billion. This sort of financing and housing administration talent and experience cannot be wasted. The legislation should be changed to incorporate and take advantage of these agencies' expertise in the extremely complicated and challenging field of providing assistance to first time homebuyers.

Conclusion

In summary, NLBMDA congratulates you, your committee and staff on your preparation of this truly innovative homebuyers assistance program. We recognize that your proposal, as drafted, represents an alternative to the existing tax-exempt, single-family mortgage revenue bond program and not a substitute. It is indeed refreshing to learn of a new housing proposal which is based on the theory that if the proposal is effective, it will "fly" on its own accord and merits. Too often the American housing industry is essentially forced by Congress and housing-related bureaucracies to accept a new housing assistance approach totally or be left out of any participation of the newly established program. We look forward to assisting you and the Committee in continuing to work out any and all problems which might become associated with this new, exciting program. We sincerely hope that the new mortgage credit certificate program becomes a successful tool in conjunction with the existing tax-exempt mortgage revenue bond program, in providing decent, safe and sanitary housing with a suitable living environment for qualified first time American homebuyers.

Respectfully submitted,

John M. Martin

John M. Martin
Executive Vice President

New York State
Mortgage Loan Enforcement &
Administration Corporation

11 West 42nd Street
New York, NY 10036
212/790-2562

Office of the President

STATEMENT FOR THE SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE

UNITED STATES SENATE

HEARINGS ON AUGUST 3, 1984 ON THE 1984 TAX
REFORM ACT LEGISLATION ON IMPUTED INTEREST
AND ORIGINAL ISSUE DISCOUNT
(OID) REVISIONS

Barbara Gordon Espejo
President and
Chief Executive Officer
New York State Mortgage
Loan Enforcement and
Administration Corporation
New York City

1984 Tax Act Imputed Interest and Original Issue Discount Revisions

Introduction

The New York State Mortgage Loan Enforcement and Administration Corporation (MLC) administers a mortgage loan portfolio of $1.2 billion of 113 low- and moderate-income uninsured multifamily residential projects as agent for, and subsidiary of, the New York State Urban Development Corporation (UDC). These project mortgages were financed by UDC through moral obligation bonds, and almost all of these project mortgages receive interest reduction payments under Section 236 of the National Housing Act.

MLC is acutely aware of the imperative capital needs of existing multifamily projects. Many of our projects are 8-12 years old and have severe capital maintenance needs which cannot be met through normal financing channels without severe disruption in tenants' rents.

As the Senate Finance Committee considers Senator John Melcher's (D-Mont.) bill (S. 2894) to broaden the range of transactions that could be exempted from certain provisions of the Tax Reform Act of 1984 (the "Act"), we strongly urge that

equal consideration be given to the need to exempt low-income multifamily housing from the Original Discount Rules (OID Rules). (See §§41 and 42 of the Act.)

An exemption from the OID Rules would provide the necessary impetus to sustain the tax incentives to raise private capital investment that has only recently begun in our portfolio. Before the OID Rules were enacted in July 1984, five projects were resyndicated and 62 potential candidates for resyndication were in the pipeline. If the pipeline for resyndication was able to move forward beyond January 1985, no less than $58 million could be obtained from the syndication proceeds to improve, rehabilitate and refinance approximately 15,000 housing units. These housing units are not the typical high-rise boxes designed for public housing tenants. Most of the units are in residential projects that have won distinguished awards for their architecture and design; but today, because of the OID Rules, they will not be attractive to private investors and it will be impossible to provide for the necessary physical improvements which would prevent them from becoming the eyesore and blight of the communities they were intended to improve.

The severe capital/maintenance needs of the projects have contributed significantly to the failure of owners to generate project income to pay debt service on these projects. Over the last few years we have only been able to collect 40-60% of the debt service on these projects. The state has had to make numerous financial contributions for emergency repairs and other project needs to avoid projects from becoming uninhabitable. In many of our projects as much as 25% of the tenants are paying in excess of 40% of their income for rent, and the State would be hard-pressed in justifying rental increases in state regulated projects to cover the costs of necessary improvements.

The Senate Finance Committee does not have to be reminded that the Administration has withdrawn its support for the type of federal assistance that originally made state-financed housing projects possible; thus, these units are irreplaceable and must be preserved for low- and moderate-income tenants as the best example of housing of last resort.

Simply put, without new subsidies, there is a critical need for the continuation of past tax incentives and an exemption from the imputed interest and OID Rules for low-income housing.

The problems, of course, are not just MLC's. A report prepared in November 1983 by the General Accounting Office for the U.S. House Committee on Government Operations identified the problem in its title: "HUD Is Not Adequately Preserving Subsidized Multifamily Housing."* Without scapegoating the Department, a few points from that report should be reiterated.

- the government's investment in the existing stock of assisted multifamily housing is virtually irreplaceable.

- with support for new construction virtually cut off, preserving existing housing stock has become even more critical.**

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* Eleventh Report by the Committee on Government Operations, "HUD Is Not Adequately Preserving Subsidized Multifamily Housing," House Report No. 98-477, 98th Congress, 1st Session, November 3, 1983.

** While the issue of HUD's inventory is beyond the scope of MLC's testimony, we might note that as of April 1983, HUD held the mortgage (i.e., a default and assignment had occurred) on 1,857 projects with a total of 248,531 units (an inventory which has been reduced, admittedly, over the intervening months). While no specific data have been collected to support this point, it seems logical to assume some percentage of this inventory could remain as healthy and viable projects if sufficient tax incentives were sustained for subsidized housing.

Discussion

I. Expansion of Original Issue Discount (OID) Rules and Restriction on Current Deductions for Accrued Interest on Deferred Obligations

The Tax Reform Act of 1984 extended the OID Rules to include, among other transactions, debt instruments that are issued for services or for the use of property. Under the tax law prior to the Tax Reform Act of 1984, certain exceptions to the OID Rules were permitted, such as for obligations issued in exchange for property or services. These rules required the issuer or holder of a bond, or other related instruments, to report net interest annually regardless of whether they were on the cash or the accrual basis.

Beginning on January 1, 1985, sellers of property taking back secondary (purchase money) financing will be obligated to recognize accrued but unpaid interest on that financing regardless of whether such sellers are cash basis taxpayers. In contrast, under present law, sellers who are cash-basis taxpayers need not report accrued interest as income until actually paid. Under the new law, sellers may have "phantom income" requiring payment of taxes on income not received. According to one official with the National Corporation for Housing Partnerships (NCHP), a major syndicator of subsidized housing, the change will essentially halt

resyndications of existing government-assisted low-income rental housing projects, which have depended on infusions of new captal cash to maintain and improve their condition.

Background and Effect on Low-Income Housing

When purchasing low-income housing, sellers have often used a cash basis of accounting and taken back some paper, either in the form of a simple residual receipts note or a non-foreclosable second mortgage. The actual payment of the secondary financing in most resyndications comes from surplus cash or at the end of the term of the note. This arrangement increases resyndication deductions and benefits the seller, buyer, mortgagee, the tenants and the property itself. The seller benefits by owning a portion of the residuals, the interest on the secondary obligation is typically accrued, but not paid until sale. The buyer benefits by having a substantially increased basis. The mortgagee, tenants and property benefit by this increased basis, because more money can be raised and made available for repairs, capital improvements, escrows, debt service and other project needs.

Secondary financing can only be included in the basis of the property if the note represents "fair market value" of the interest. Since both buyer and seller have incentive to set the secondary financing as high as possible,

Congress adopted provisions in the Tax Equity and Fiscal Responsibility Act of 1982 which increased the penalties for overvaluation of properties for purposes of inflating tax deductions. In another measure to prevent potential abuse, the American Bar Association issued ethical guidelines for attorneys reviewing partnership offerings that require them to inform potential investors of questionable tax assumptions. Furthermore, guidelines for HUD approval of transfers of federal housing projects under its jurisdiction strictly limit the amount of secondary financing which may be placed thereon.

As one Harvard-MIT study concluded, "Agencies should allow secondary financing in the sale of any project if its market value can justify the total indebtedness." *** Similarly, testimony submitted on behalf of the Coalition of Low and Moderate Income Housing and the National Leased Housing Association before the U.S. House Ways and Means Committee last February concluded: "The use of the purchase money note allows the new partnership which is purchasing the property to use less of the cash raised from the new investors to pay the old owners and to spend more of it on upgrading the property."

*** "Developing State Policies on the Sale and Resyndication of Subsidized Housing," by William N. Rumpf. Working Paper No. W83-8 Joint Center for Urban Studies of MIT and Harvard University, 1983.

Increased resyndication proceeds resulting from the secondary financing described above are needed for low-income subsidized housing for several reasons:

- Congress has always recognized the need for federal tax incentives to attract private capital for subsidized housing in order to offset the inability of low-income tenants to pay rents that are adequate to cover operating expenses. In addition, use of resyndication proceeds to address project repairs and other needs in this manner is more expeditious and cost-effective than payments and administration of tenant subsidies.

- Just as the limited rent affordability of low-income tenants discourages private capital investment in low-income housing, federal and state regulations typically limit the cash distributions to owners of subsidized housing to 6-10 percent of original equity capital. Therefore, even if a low-income project could generate a sufficient income to pay a portion of

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- interest on the secondary financing, regulatory restrictions would generally permit only a small fraction of that total to be paid out.

- Many subsidized housing projects are eight or more years old and currently need sizable cash infusions for repairs, energy conservation and capital improvements, and other project needs. Current owners are often unwilling to provide additional capital contributions for these projects because the rent levels cannot provide an adequate rate of return on their investment, and additional tax benefits to the existing owners are exhausted.

- It is often difficult to enforce the mortgage obligations and, absent a strong threat of foreclosure, owners will not provide additional investment for repairs and debt service. Several governmental mortgages, including HUD and our own Corporation, have attempted to initiate stronger enforcement and legislative measures, including adoption of expedited

foreclosure laws. However, the foreclosure laws have encountered legal problems and the enforcement actions have met delaying tactics by delinquent owners.

- Funding has been substantially reduced or eliminated for federal subsidy programs that directly subsidize project operations through low-cost mortgage financing and/or guaranteed rental income.

- Absent the threat of foreclosure, owners will generally be reluctant to sell their project unless they are compensated for their full tax liability including recapture of excess depreciation benefits at ordinary income.

- HUD and state mortgagees/regulatory agencies generally require that all repairs be completed, and the project made physically sound, within two years of a transfer, and that project reserves by fully funded within 18 months after the transfer. Unless an adequate amount of equity can be raised to address these project needs, as required by governmental policy, there will be no purchaser or transfer or influx of new funds for the project.

II. Treatment of Stated Interest Rate on Such Note.

In addition to the expansion of the OID Rules, the scope of the imputed interest rules of Internal Revenue Code §483 is restricted for sales or exchanges occurring after 1984 (other than a sale or exchange pursuant to a written contract that was binding on March 1, 1984, and thereafter before the sale or exchange). Thus, Code §483 applies only to a deferred payment transaction involving a sale of property that is exempted from the OID Rules.

With certain exceptions, the OID Rules apply to a privately placed debt instrument given in consideration for the sale or exchange of property if (1) the stated redemption price at maturity exceeds either the stated principal amount (if there is adequate stated interest) or the testing amount (if there is inadequate stated interest); and (2) some or all of the payments due under the debt instrument are due more than six months after the date of the sale or exchange. Under these OID Rules, the safe harbor rate used to determine if there is unstated interest under a contract is an imputed principal amount based on the sum of the present values of all payments due under the instruments, discounted at 110% of the applicable federal rate (short-term, mid-term or long-term, depending on

the length of the contract), and compounded semiannually. Further, the rate used to determine the amount of imputed interest under a contract with unstated interest is 120% of the applicable federal rate, compounded semiannually.

The imputed interest rate, as determined under the above rules, is to be included in the income of the seller and deductible by the buyer in accordance with their respective accounting methods in cases where payment is made on the cash basis and liability is incurred on the accrual method.

Whereas the OID Rules under the Act are made to apply to subsidized housing for low income families, they do not apply to the following "protected property transactions":

A. Sales for less than $1 million of farms by individuals or small business.

B. Sales of principal residences.

C. Sales involving total payments of $250,000 or less.

D. Debt Instruments which are Publicly Traded or Issued for Publicly Traded Property.

E. Certain Sales of Patents.

F. Sales or Exchanges to which Section 483(e) applies (relating to certain land transfers between related persons).

The requirement to compute interest on a compound basis applies to transactions occurring on or after June 8, 1984. However, the other provisions, including the tax on the seller's phantom income (where the seller must report as income interest deductible by the buyer, regardless of whether any cash is paid) will not take effect until January 1, 1985.

Background and Effect on Low-Income Housing

Prior to the 1984 Tax Reform Act, the threshold amount of interest accruing on a purchase money (second) mortgage set by the I.R.S. under §483 was 9 percent simple interest rate. The new rules requiring compound interest rates produce several disincentives to new investors:

- Use of compound, rather than simple, interest reduces the amount of interest deductions in the early years.

- Use of compound interest increases the overall percentage of indebtedness which is deemed to represent interest. Since a larger portion is interest, a corresponding small portion of total indebtedness is principal.

- Reduction of the principal portion means less basis for the buyer for purposes of computing depreciation deductions.

- As a result, a purchaser's deductions for both depreciation and interest in the initial years of ownership will be reduced.

- The net effect is that a portion of principal would be recharacterized as interest, and thereby recognizable as ordinary income to the seller and deductible by the buyer.

New investors will therefore have fewer tax incentives to provide necessary capital contributions for deteriorating low-income projects. Fewer deductions will mean fewer syndication proceeds that can be raised, and, net of syndication fees and other transaction costs, less money for project needs.

Conclusion:

Exemption for low-income housing from the Original Issue Discount (OID) and Imputed Interest rules in the 1984 Tax Reform Act is needed for several reasons:

- Recognizing the limited supply of multifamily housing and the limited ability of low and moderate-income families to pay for such housing, Congress has consistently applied federal tax incentives as the most efficient mechanism for attracting private capital for subsidized housing. These incentives, however, have now been severely by damaged by the OID and imputed interest revisions in the 1984 Tax Act.

- Because of limited tenant incomes and limited amount of distributions from cash flow to the owner, private capital contributions for repairs and other improvements must come from non-project sources. However, direct governmental program subsidies have been reduced and additional tax benefits to the existing

- owners are inadequate. Moreover, foreclosure and other enforcement remedies against recalcitrant owners, which often induce added capital contributions have encountered legal problems.

- Resyndication has proven in the past 2-3 years to be the most efficient and effective means for repairing and stabilizing the physical and financial condition of low-income subsidized housing. Secondary financing and simple interest rules benefit not only the buyer, seller, mortgagee, and tenants; but, most importantly, the property and the federal investment in existing low-income housing projects.

- For these reasons, we urge you to include in Senator Melcher's Senate Bill 2894 an exemption for low-income multifamily housing from the Imputed Interest and Original Issue Discount (OID) rules. According to testimony by the Coalition of Low and Moderate Income Housing and the National Leased Housing Association before

the U.S. House Ways and Means, Committee last February 28, such an exemption would cost on a "worst case" analysis only $10-15 million per annum. We believe this is a small cost for the enormous benefits derived for housing our low-income population.

August 16, 1984

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Gentlemen:

Please include the content of this letter in the printed record for the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

Having taken the time and effort to try and understand the significance of the proposed 1984 tax reform act, I have reached a conclusion that the content of this act is not in the best interest of any of the proposed involved parties. I therefore believe that this 1984 tax reform act should be repealed. I believe that the involved considerations of this act will substantially disrupt many current and future real estate transactions.

As it is, those sellers carrying private mortgages are to charge interest rates of nine percent (9%) or be taxed as though they were receiving a ten percent (10%) equivalent. I feel these numbers are fair and represent a level at which continued real estate transactions are available. However, to charge 110% of a proposed long term security rate is absurd. If todays average interest rate for long term security is a 13.5 equivalant and we need to charge 110% of that or be penalized at 120% then we are in the range of 15% - 16% interest equivalent and this is not attainable in todays marketplace. There is no way, I repeat, absolutely no way that a purchaser of any intelligence can and/or will agree to pay interest rates at this level. Therefore, this act will seriously harm the potential for a sale on behalf of all sellers considering owner carry terms. This would ultimately result in a decrease in property value and a proposed increase in both inflation and rents.

I would personally prefer that congress repeal all the current changes of inputed interest rate rules before they become effective.

I look forward to your positive and immediate response regarding this matter as the best interests of the consumer public are not and will not be served by these proposed changes.

Sincerely,

Thomas H. Porter

Thomas H. Porter
1120 Johnson
Lakewood, Colorado 80215

TP/lc

c: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart
Congressman Hank Brown
Congressman Ray Kogovsek
Congressman Ken Kramer
Congresswoman Patricia Schroeder
Congressman Timothy Wirth

JOHN F. PHELPS

1152 Emerson Street
Denver, CO 80218

August 10, 1984

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD 219
Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. DeArment:

Please include this letter in the printed record of the Hearing on the Changes to the "Imputed Interest Rules" of Code Section 483 and New Code Section 1274.

After having reviewed the changes to the "Imputed Interest Rules" of Section 483 by the enactment of Section 1274, I am concerned that such changes may act against the best interests of the taxpayers, the Internal Revenue Service and its Agents, and the country as a whole. Simply, they seem to be far too complicated and their management questionable.

First, unless one is a highly-trained Certified Public Accountant or attorney specializing in tax matters, my guess is that most people will not be able to understand the Code. The vast majority of people involved in smaller real estate transactions probably never consult a CPA; hence, compliance with the new Code may be less than expected. Furthermore, the IRS may not be able to monitor compliance because many of the Agents will have difficulty understanding the "present value computations" of Section 1274.

Several economic questions arise when reviewing these changes.

1. Why should an individual who carries back a note on the property he is selling charge interest rates nearly equal to those of commercial institutions, when the individual has no overhead to manage those note costs? Doesn't it follow his costs are lower, so his interest rate should reflect his lower costs?

2. Why should a taxpayer pay taxes on imputed interest, when he is not receiving that interest, and there are no "safe" instruments in the market place which will pay him an interest equal to the imputed interest on which he is paying taxes? In reality, his imputed interest should be equal to the short-term key note yield or less.

3. Isn't the creation of new real estate transactions (i.e., building of homes, apartments, commercial units) slowed when there are no alternatively lower financing vehicles available for those people who have involved themselves in real estate? Doesn't the Government end up footing the bill for low cost housing and commercial centers when private development is slowed? Will the taxes collected on a higher imputed rate offset the slower increase in housing units and commercial support units?

I believe that the benefits of the changes in the Code concerning "Imputed Interest Rules" are offset by the inherent complications by the changes. Problems with compliance, enforcement, fairness and structure seem to outweigh the possible increase in revenues derived by such change.

My inclination is to discuss more direct revenue-raising measures, rather than to approach the problem by digging deep into the Code and complicating an already difficult set of rules. Please consider my remarks.

Cordially,

John F. Phelps

c: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart

August 21, 1984

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Gentlemen:

I would like to have this letter included in the printed record for the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

I feel that the New Code Section 1274 enactment has created an extremely complicated and unmanageable situation for not only attorneys, but the average taxpayer. This new enactment has become an issue whereby no one, but possibly a C.P.A. can understand its effects primarily in the area of the sale of real property. Taking into account the imputed interest rules of Code Section 483 and how difficult this tax law was to understand, New Code Section 1274 has not helped the average taxpayer understand any better how the tax laws work, and if they are a benefit or not to his certain situation.

In dealing with the mechanics of real property transactions, the complicated rules of Section 1274 could be followed exactly prior to closing, however, if interest rates change in the interim, this change could cause the transaction to no longer comply with Section 1274, and thus resulting in a penalty to the seller, who thought he was complying with the law when he signed the contract. Obviously, when Congress enacted Section 1274, they did not understand the logistics of real estate.

As you can see, Congress has created a "monster". Taxpayers who are entering into real property transactions which result in contractual agreements, have no way of determining the tax consequences of such transactions under Section 1274. To force a seller and commercial lender to a real estate transaction to charge a rate of interest greater than treasury rates or commercial lending rates is a highly inflationary measure, especially in land transactions that eventually end up as subdivided home sites which reflect a higher carryback interest rate in the final home site sale to the consumer. Such a law is counterproductive to Congress' intent to reduce inflation. What this country does not need is higher priced housing and a higher cost of doing business!

If Section 1274 cannot be repealed, and it should be, then the testing rate should be reduced to 80 percent of an appropriate treasury note yield (which would be approximately the NOW account rates) and the penalty rate should be equal to the appropriate treasury note yield. Furthermore, and most importantly, the rate should be the applicable rate at the date the contract is entered into, not the date of the closing of the real estate transaction.

I think it is most important for Congress to understand that by changing the rates really has no appreciable effect on government revenues. Under Section 483 and 1274, to the extent the seller's interest income is increased, the buyer's interest deduction is also increased resulting in no gain to the treasury. In other words, for each dollar of interest income, there would be a matching dollar of interest deduction.

Very truly yours,

Ronald P. Roberts

Ronald P. Roberts
955 South Clayton Way
Denver, Colorado 80209

cag

c: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart
Congressman Hank Brown
Congressman Ray Kogovsek
Congressman Ken Kramer
Congresswoman Patricia Schroeder
Congressman Timothy Wirth

August 24, 1984

The Honorable Robert J. Dole
United States Senate
Washington, D.C.

Dear Senator Dole:

The Dallas Times Herald published an article, on Monday, August 13, 1984, concerning the possibility of the taxation of employee benefits. You were quoted as saying,

> "to the extent narrowing the tax base causes pressure to increase marginal tax rates, these tax-free benefits will only appear to be free, because ultimately every taxpayer will have to pay for them in the form of higher taxes on the portion of his compensation that is subject to taxes."

I understand that one of this nation's most important problems is the Federal deficit. Obviously, any additional income may temporarily ease the pressure of the growing deficit.

However, I do not believe that planning a tax on employee benefits is the correct method of solving the deficit problems.

I feel one reason that employee benefits are an inviting target for taxation is the misconception that these benefits are only for the rich. This is far from the truth. For the record, I earn approximately $17,500.00 per year. (The majority of employees covered by pensions and health plans earn less than $25,000.00 per year.) I do agree that tax-exempt status should be provided only for those benefits that are provided in an equal manner to all employees.

As to who would be hurt if benefits were taxed, let me suggest that these taxes would harm each and every person in the United States of America!

The taxation of pension benefits would, in many cases, make the cost prohibitive to the employer. The lack of private pension systems would soon cause the Social Security Administration to greatly raise its payments, in order to keep the retired employee above the poverty level.

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August 24, 1984

The Honorable Robert J. Dole
United States Senate
Page 2.

The taxation of health coverage (one of the costliest, and most inflation-prone areas of the economy) would quickly place the cost at a level beyond the reach of the employer. The employee would, as well, be unable to purchase coverage. Without private health care coverage, the nation would be forced to begin a national health care system. Such a system would cost far more, in dollars, than the revenue raised by taxing the coverage.

I know that you are a caring individual. I trust that you will be able to see that the taxation of pension plans and health care coverage will ultimately place a tremendous burden on the American taxpayer, and will not relieve any current problems.

Thank you for your time in reading this letter.

Sincerely,

Richard A. Root

Richard A. Root
106 W. Celeste
Garland, Tx. 75041

cc: Sen. Bob Packwood
Sen. Lloyd Bentsen

/at

August 21, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Gentlemen:

I wish this letter to be included in the printed record of the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

The new law taking effect on January 1, 1985, has already had an impact on my clients, whom I serve as their commercial real estate broker/agent. A number of properties have been placed on the market recently in order to bring about a sale this year, before the new law takes affect. Many of my clients have expressed feelings that it will be much more complicated and perhaps impossible for them to sell their commercial properties because of the new imputed interest rate law.

Many more of my clients would be upset with the new law; if they knew that it existed. I foresee a tremendous uproar after the first of the year from owners of commercial real estate. You would hear from more of them now if they knew about the law and its affect.

Your new law makes the process much too complicated. It makes it impossible to predict into the near future what the interest rate of the carryback is going to have to be.

I would suggest that you let the market place set the interest rate on a seller carryback. There is nothing better than the free market place to to that. It would be uncomplicated and simple with respect to arms length transactions.

It would be best for you to repeal the new imputed interest rate law and let the market place have its affect on the interest carryback.

Very truly yours,

Stanley Shapiro

SS:sg
Broker/Salesman
Fuller and Company

August 16, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, DC 20510

Gentlemen:

I wish this letter to be included in the printed record of the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

The changes made to the "imputed interest rules" of Section 483 by the enactment of Section 1274, at least in the aura of the sale of real property, has created a wholly unnecessary and unmanageable complicity to an area of the tax law that was already too complicated to be understood by any taxpayer other than CPA's. The average attorney, let alone the average taxpayer, could not understand the present value discounting rules of Section 483. Section 1274 is TOO COMPLICATED to be understood by all except mathematicians and CPA's.

To tie the interest rates on a seller carryback of real property to 120% of the interest rate charged on federal treasury instruments, thereby making the interest rate greater than that charged by commercial lenders, fails to recognize several significant economic differences between sellers of real property who "carryback" financing on the one hand and commercial lenders on the other hand.

(1) The commercial lender has a fully operating business staffed by several employees and involving a significant capital investment. The commercial lender has to charge two to three interest points above its cost of money to cover its cost of doing business, a return on its capital and a profit amount. The individual seller does not have such costs and in most real property transactions the seller of real property will carryback financing two to three interest points below commercial market rates because he has no cost of doing business.

(2) Secondly, the interest rate that a seller receives on a carryback is generally equivalent to what such seller would receive from an investment in a fixed income investment, such as treasury notes, corporate bonds and bank savings accounts. Today a commercial lender on a loan secured by a real property is commanding a 13-3/4% to 14% rate. The current interest rate being paid on money market accounts is about 10½%. On

the other hand, 120% of the current short-term T-note yield would be approximately 14.7%. Under Section 1274 the law requires the seller to report an interest income forty percent greater than what such seller would receive from available alternative investments.

(3) When the seller carries back financing, the debt instrument owned by the seller is secured by a lien on the property sold. In almost all cases the seller has "first rate security" for the payment of his loan. The greater the security the lower the interest rate should be. On the other hand, if a person is willing to risk his capital, such as in the purchase of a corporate bond, then the interest rate should be higher. The upper interest rate level under Section 1274 should be equal to the treasury note yields, not 120% of such yields.

In enacting Section 1274 the economics of real property transactions were not adequately understood. In many real estate transactions the time period between the parties entering into an Agreement for Sale and the actual closing of the transaction (i.e. the transfer of title and payment) can be many months to even years. For example, in a raw land transaction the closing may be contingent upon rezoning or platting and because of the governmental process, may be upwards of two years time span between the contract date and the closing date. Frequently, in a lease transaction, the lessee may be granted the option to purchase the property five or ten years later. All of the terms of the Purchase Agreement must be provided for in the lease/option agreement. In most real property transactions, the time difference between contractual agreement and closing is from 60 days to 180 days. In all of the above examples, because of the time lag, a contract could be entered into complying with the complicated rules of Section 1274 and prior to closing, the interest rates could change causing the transaction at closing to no longer comply with Section 1274. Congress has created an intolerable situation for real property transactions in that people who are entering into contractual agreements will have no way of determining the tax consequences of such transactions at the time of signing such Real Property Purchase and Sale Agreements. One of the very basic tenants of tax law has been that it should be clear, understandable, and taxpayers should be able to measure the tax consequence of thier acts at the time they are entering into agreements. This can not be accomplished in a real estate transaction under Section 1274.

Under the old rules of Section 483, a taxpayer could calculate the tax consequences of his acts. Under the new Section 1274, very few taxpayers, and very few IRS agents, would be able to calculate the tax results of a transaction. Furthermore, a reasonable rate of interest should be the measuring device, not a rate of interest that is in excess of a rate of interest charged by the most expensive of commercial real property lenders.

To force the parties to a real estate transaction to charge a rate of interest greater than treasury rates of commercial lending rates is a highly inflationary measure. Such a law is counterproductive to Congress' intent to reduce inflation. Its primary impact will be to increase the cost of living and commercial properties. What this country doesn't need is high priced housing.

If Section 1274 cannot be repealed, then the testing rate should be reduced to 80% of an appropriate treasury note yield and the top rate should be equal to the appropriate treasury note yield. Furthermore, the rate should be the applicable rate at the date the contract is entered into, not the date of closing of the real estate transaction.

To change the rates would not have any appreciable effect on government revenues. Under Sections 483 and 1274, to the extent the seller's interest income is increased, the buyer's interest deduction is also increased resulting in offsetting each other. In other words, for each dollar of additional interest income there would be a matching dollar of interest deduction.

Very truly yours,

Gene R. Stanich

GRS/jr
cc: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart

August 13, 1984

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Gentlemen:

I would like to have this letter included in the printed record for the hearing on the changes to the imputed interest rules of Code Section 483 and New Code Section 1274.

As I see it, the changes made to the "imputed interest rules" of Section 483 by the enactment of Section 1274, at least in the area of the sale of real property, has created a wholly unnecessary and unmanageable situation to an area of the tax law that was already almost too complicated to be understood by any taxpayer other than a C.P.A. In my experience, the average attorney, let alone the average taxpayer, was having a hard enough time trying to understand the present value of the discounting rules of Section 483. Now Congress has added a further complication that will certainly eliminate the taxpayer, as well as most attorneys and Internal Revenue Service agents, from being able to understand the effects of the New Code. Section 1274 is altogether too complicated to be understood by anyone except the C.P.A. who may be able to guarantee what the treasury bill rates will be six months from the date he signs a contract to sell real estate.

In enacting Section 1274, the mechanics of real property transactions were not adequately understood by Congress. The problem is that in many real estate transactions, the time period between the parties entering into an agreement for sale and the actual closing of the transaction (i.e.; the transfer of title and payment) can be many months to even years apart. For example, in a raw land transaction, the closing may be contingent upon rezoning and/or platting and because of the local governmental process, there may be upwards of a year or two time span between the contract date and the closing date. In most commercial, industrial or investment property transactions, the time difference between contractual agreement and actual closing usually runs from 90 to 120 days. Because of the time lag, a contract could be entered into complying with the complicated rules of Section 1274 and prior to closing, the interest rates could change causing the transaction to no longer comply with Section 1274 at closing, thereby assessing a penalty against a seller of the property who thought he was complying with the law when he signed the contract.

As you can see, Congress has created an intolerable situation for real property transactions of this type. Taxpayers who are entering into contractual agreements will have no way of determining the tax consequences of such transactions. One of the very basic tenets of tax law has been that it should be clear, understandable and taxpayers should be able to measure the tax consequence of their acts at the time they are entering into agreements. Congress should understand that this cannot be accomplished in a real estate transaction under Section 1274. Under the old rules of Section 483, a taxpayer could calculate the tax consequence of his acts. Under the new section, very few taxpayers and even fewer Internal Revenue Service agents, C.P.A.s and attorneys would be able to calculate the tax results of a transaction.

Furthermore, a reasonable rate of interest should be the measuring device, not a rate of interest that is in excess of a rate of interest charged by the most expensive of commercial real property lenders. To tie the interest rates on a seller carryback of real property to 110 percent of the interest rate charged on federal treasury instruments, thereby making the interest rate greater than that charged by commercial lenders, fails to recognize two significant economic differences between sellers of real property who must carryback financing to sell their property on the one hand and commercial lenders on the other hand.

1. The commercial lender has a fully operating business staffed by several employees and involving a significant capital investment. The commercial lender has to charge two to three interest points above its cost of money to cover its cost of doing business, a return on its capital and a profit amount. The individual seller does not have such costs and, in most real property transactions, the seller of real property will carryback financing two to three interest points below commercial market rates because he has NO cost of doing business.

2. Secondly, the interest rate that a seller receives on a carryback is generally equivalent to what such seller would receive if he had sold the property for cash and put the money in a bank savings account (NOW account).

To force the parties to a real estate transaction to charge a rate of interest greater than treasury rates or commercial lending rates is a highly inflationary measure, especially in land transactions that eventually end up as subdivided home sites which reflect the higher carryback interest rate in the final home site sale to the consumer. Such a law is counterproductive to Congress's intent to reduce inflation. Its primary impact will be to increase the cost of living and the additional cost will also be reflected in the final product. What this country does not need is higher priced housing and a higher cost of doing business!

If Section 1273 cannot be repealed, and it should be, then the testing rate should be reduced to 80 percent of an appropriate treasury note yield (which would be approximately the NOW account rates) and the penalty rate should be equal to the appropriate treasury note yield. Furthermore, and most importantly, the rate should be the applicable rate at the date the contract is entered into, not the date of the closing of the real estate transaction.

I think it is most important for Congress to understand that by changing the rates really has no appreciable effect on government revenues. Under Section 483 and 1274, to the extent the seller's interest income is increased, the buyer's interest deduction is also increased resulting in no gain to the treasury. In other words, for each dollar of interest income, there would be a matching dollar of interest deduction.

Very truly yours,

Albert I. Strauch
4327 South Yosemite Court
Englewood, Colorado 80111

kp

c: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart
Congressman Hank Brown
Congressman Ray Kogovsek
Congressman Ken Kramer
Congresswoman Patricia Schroeder
Congressman Timothy Wirth

HOWARD H. TORGOVE

August 15, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Gentlemen:

I wish this letter to be included in the printed record of the hearing on the changes to the imputed interest rules of the Code Section 483 and New Code Section 1274.

To tie the interest rates on a seller carryback of real property to 120% of the interest rate charged on federal treasury instruments, thereby making the interest rate greater than that charged by commercial lenders, fails to recognize several significant economic differences between sellers of real property who "carryback" financing on the one hand and commercial lenders on the other hand.

Because commercial lenders have both over-head costs and significant capital investment, they have to charge two to three interest points above their cost of money to cover the cost of doing business, a return on their capital and a profit amount. The individual seller does not have such costs and in most real property transactions the seller of real property will carryback financing at two to three interest points below commercial market rates because he has no cost of doing business.

Secondly, the interest rate that a seller receives on a carryback is generally equivalent to or below what such seller would receive from an investment in a fixed income investment, such as treasury notes, corporate bonds and bank savings accounts. Today a commercial lender on a loan secured by real property is commanding 13-3/4% to 14% rate. The current interest rate being paid on money market accounts is about 10-1/2%. On the other hand, 120% of the current short-term T-Note yield would

be approximately 14.7%. Under Section 1274 the law requires the seller to report an interest income forty percent greater than what such seller would receive from available alternative investments.

When the seller carrys back financing, the debt instrument owned by the seller is secured by a lien on the property sold. In almost all cases the seller has "first rate security" for the payment of his loan. The greater the security, the lower the interest rate should be. On the other hand, if a person is willing to risk his capital, such as in the pruchase of a corporate bond, then the interest rate should be higher. The upper interest rate level under Section 1274 should be equal to or less than the treasury note yields, not 120% of such yields. A reasonable rate of interest should be the measuring device, not a rate of interest that is in excess of a rate of interest charged by the most expensive of commercial real property lenders.

Furthermore, to force the parties to a real estate transaction to charge a rate of interest greater than treasury rates or commercial lending rates is a highly inflationary measure. Such a law is counterproductive to Congress' intent to reduce inflation. Its primary impact will be to increase the cost of living by raising the rents on residential and commercial properties. What this country doesn't need is higher priced housing or more inflation.

If Section 1274 cannot be repealed, then the testing rate should be reduced to 80% of an appropriate treasury note yield and the top rate should be equal to the appropriate treasury note yield. Furthermore, the rate should be the applicable rate at the date the contract is entered into, not the date of closing of the real estate transaction.

The changes were "full of sound and fury, signifying nothing." To change interest rates would not have any appreciable effect on government revenues. Under Sections 483 and 1274, to the extent the seller's interest income is increased, the buyer's interest

deduction is also increased resulting in offsetting each other. In other words, for each dollar of additional interest income there would be a matching dollar of additional interest deduction.

Very truly yours,

Howard H. Torgove

HHT:mg

cc: Senator Robert Packwood
Senator Robert J. Dole
Senator John C. Danforth
Senator John H. Chafee
Senator Malcolm Wallop
Senator Russell B. Long
Senator Lloyd Bentsen
Senator Spark M. Matsunaga
Senator Max S. Baucus
Senator William L. Armstrong
Senator Gary Hart

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August 13, 1984

Roderick A. DeArment
Chief Counsel
Committee on Finance
Dirksen Senate Office Building
Room SD-219
Washington, D.C. 20510

Dear Mr. DeArment:

I wish this letter to be included in the printed record of the hearing on the changes to the "imputed interest rules" of Code Section 483 and New Code Section 1274.

The changes made to the "imputed interest rules" of Section 483 by the enactment of Section 1274, at least in the area of the sale of real property, has created a wholly unnecessary and unmanageable complicity to an area of the tax law that was already too complicated to be understood by any taxpayer other than CPA's. In my experience, the average attorney, let alone the average taxpayer, could not understand the present value discounting rules of Section 483. Now you have added a further complication that will certainly eliminate almost all of the Internal Revenue Service Agents from being able to understand and audit compliance with the law. Section 1274 is TOO COMPLICATED to be understood by all except mathematicians and CPA's.

In real estate transactions, I would suggest there will be little compliance with the law unless both the purchaser and the seller have CPA's prepare their income tax returns. Furthermore, the IRS will not be able to monitor compliance because the vast majority of Internal Revenue Agents will not be able to understand the "present value computations" of Section 1274.

To tie the interest rates on a seller carryback of real property to 120% of the interest rate charged on Federal treasury instruments, thereby making the interest rate greater than that charged by commercial lenders, fails to recognize several significant economic differences between sellers of real property who "carryback" financing on the one hand and commercial lenders on the other hand.

(1) The commercial lender has a fully operating business staffed by several employees and involving a significant capital investment. The commercial lender has to charge two to three interest points above its cost of money to cover its cost of doing business, a return on its capital and a profit amount. The individual seller does not have such costs and, in most real property transactions, the seller of real property will carryback financing two to three interest points below commercial market rates because he has no cost of doing business.

(2) Secondly, the interest rate that a seller receives on a carryback is generally equivalent to what such seller would receive from an investment in a fixed income investment, such as treasury notes, corporate bonds and bank savings accounts. Today a commercial lender on a loan secured by real property is commanding a 13-3/4% to 14% rate. The current interest rate being paid on money market accounts is about 10-1/2%. On the other hand, 120% of the current short-term T-Note yield would be approximately 14.7%. Under Section 1274 the law requires the seller to report an interest income forty percent greater than what such seller would receive from available alternative investments, were he to sell his property for cash.

(3) When the seller carries back financing, the debt instrument owned by the seller is secured by a lien on the property sold. In almost all cases, the seller has "first rate security" for the payment of his loan. The greater the security, the lower the interest rate should be. On the other hand, if a person is willing to risk his capital, such as in the purchase of a corporate bond, then the interest rate should be higher. The upper interest rate level under Section 1274 should be equal to the treasury note yields, not 120% of such yields.

In enacting Section 1274, the economics of real property transactions were not adequately understood. In many real estate transactions, the time period between the parties entering into an Agreement for Sale and the actual closing of the transaction (i.e., the transfer of title and payment) can be many months, even years. For example, in a raw land transaction, the closing may be contingent upon rezoning or platting and, because of the governmental process, may be upwards of two years time span between the contract date and the closing date. Frequently, in a lease transaction, the lessee may be granted the option to purchase the property five or ten years later. All of the terms of the Purchase Agreement must be provided for in the lease/option agreement. In most real property transactions, the time difference between contractual agreement and closing is from 60 days to 180 days. In all of the above examples, because of the time lag, a contract could be entered into complying with the complicated rules of Section 1274 and prior to closing, the interest rates could change, causing the transaction at closing to no longer comply with Section 1274. Congress has created an intolerable situation for real property transactions in that people who are entering into contractual agreements will have no way of determining the tax consequences of such transactions at the time of signing such Real Property Purchase and Sale Agreements. One of the very basic tenants of tax law has been that it should be clear, understandable, and taxpayers should be able to measure the tax consequence of their acts at the time they are entering into agreements. This can not be accomplished in a real estate transaction under Section 1274.

Under the old rules of Section 483, a taxpayer could calculate the tax consequences of his acts. Under the new Section 1274, very few taxpayers, and even fewer IRS agents, would be able to calculate the tax results of a transaction. Furthermore, a reasonable rate of interest should be the measuring device, not a rate of interest that is in excess of a rate of interest charged by the most expensive of commercial real property lenders.

To force the parties to a real estate transaction to charge a rate of interest greater than treasury rates or commercial lending rates is a highly inflationary measure. Such a law is counterproductive to Congress' intent to reduce inflation. Its primary impact will be to increase the cost of living and commercial properties. What this country doesn't need is high-priced housing.

If Section 1274 cannot be repealed, then the testing rate should be reduced to 80% of an appropriate treasury note yield and the top rate should be equal to the appropriate treasury note yield. Furthermore, the rate should be the applicable rate at the date the contract is entered into, not the date of closing of the real estate transaction.

Th change the rates would not have any appreciable effect on government revenues. Under Sections 483 and 1274, to the extent the seller's interest income is increased, the buyer's interest deduction is also increased resulting in offsetting each other. In other words, for each dollar of additional interest income there would be a matching dollar of interest deduction.

Very truly yours,

Lawrence E. Wright

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